

# KEEGAN, WERLIN & PABIAN, LLP

ATTORNEYS AT LAW  
265 FRANKLIN STREET  
BOSTON, MASSACHUSETTS 02110-3113  
(617) 951-1400

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R.I. PUBLIC UTILITIES COMMISSION  
TELECOPIERS:  
(617) 951-1354  
(617) 951-0586

November 14, 2003

## VIA HAND DELIVERY

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

Re: Docket No. 3548; Distribution Adjustment Clause Factors

Dear Ms. Massaro:

On October 30, 2003, the Commission allowed an interim Distribution Adjustment Charge ("DAC") factor to go into effect for New England Gas Company (the "Company") for consumption occurring on and after November 1, 2003. In accordance with the Commission's directives, the interim DAC reflects a factor for the Earning Sharing Mechanism ("ESM") based on the calculation presented by Mr. Effron in Schedule DJE-2S. The Commission implemented the interim DAC factor pending the Company's filing of a brief on issues relating to the calculation of the ESM. In these comments, the Company will address the interaction of its Service Quality Plan ("SQP") and the ESM, as well as the issue of treating the cost of employee incentive compensation as an operating cost in calculating the ESM.

### I. Statement of the Issue

Pursuant to a bench decision on May 23, 2002, and an open meeting decision on August 28, 2002, the Commission approved a settlement agreement in Docket 3401 (the "Rate Settlement"). Docket 3401, Order No. 17381 (the "Order"). With respect to the ESM, the Rate Settlement states the following:

The Settling Parties agree that a properly structured incentive-based rate plan can align the interests of the Company and its customers by establishing appropriate incentives to maximize merger-related savings for the benefit of the Company and its customers. To that end, the Settling Parties agree that the Company will implement an earnings-sharing mechanism ("ESM") to provide for the sharing of net merger-related savings,

that may be achieved in excess of those identified and incorporate into the consolidated revenue requirement. The ESM will remain in place for the period July 1, 2002 through June 30, 2010 (emphasis added).

Rate Settlement, Section II.F, at page 10.

With respect to the SQP, the Rate Settlement states the following:

The Settling Parties agree that the quality of service experienced by customers is an important factor in consolidating the operations of the New England Gas Company. The Company and the Division will continue ongoing discussions regarding the development and implementation of a Service Quality Program, with the intention of submitting a proposal to the Commission no later than September 30, 2002, for review and approval in a separate proceeding. If the Company and the Division cannot agree on a Service Quality Plan, the Company will file its own proposal by September 30, 2002. Any Service Quality Plan filed with the Commission will include a system of penalties and penalty offsets. In addition, the Company's ability to participate in the ESM will be linked to the establishment of the Service Quality Plan (emphasis added).

Rate Settlement, Section II.M, at page 19-20.

In accordance with the terms of the Rate Settlement, the Company filed a Service Quality Plan ("SQP") on September 30, 2002. Following an adjudicatory process, the Commission approved the Company's SQP on June 30, 2003. As a result, there is an approved SQP in place for FY2004 and there is no question that the ESM is operative. The question raised in this proceeding, therefore, is the following:

Does the language of the Rate Settlement (stating that "the Company's ability to participate in the ESM will be linked to the establishment of the Service Quality Plan") mean that the ESM is not in place during the period July 1, 2002 through June 30, 2003 (FY2003) because the SQP was implemented, but not formally approved by the Commission until June 30, 2003?

As discussed below, there is no basis to delay implementation of the ESM for earnings generated during FY2003 because the express language of the Rate Settlement, the Commission's Order approving the Rate Settlement and the overall intent and design of the Rate Settlement dictate otherwise.

## II. Legal Standard

Generally, under Rhode Island law, settlements must be enforced according to their terms and consistent with the intent of the settling parties. See, e.g., Homar, Inc. v. North Farm Associates, 445 A.2d 288, 289 (R.I. 1982) (recognizing that settlement agreements constitute binding contracts). Where the terms of the agreement are clear and unambiguous, the courts will adhere to the plain, ordinary and usual meaning of the agreement. Supreme Woodworking Co., Inc. v. Zuckerberg et al, 82 R.I. 247 (1954), citing Antone v. Vickers, 610 A.2d 120, 123 (R.I.1992). Where the terms of the agreement are determined to be ambiguous, then courts will look to the intent of the settling parties. Johnson, 641 A.2d at 48, citing D.T.P., Inc. v. Red Bridge Properties, Inc. 576 A.2d 1377, 1381-82 (R.I. 1990); see also, W.P. Associates, 637 A.2d at 356 (R.I. 1994). The standard for a finding of ambiguity is that an agreement is ambiguous when it is reasonably and clearly susceptible to more than one interpretation. Forcier, 637 A.2d 353, 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).

In reviewing and interpreting previous settlements it has approved, the Commission has pointed out that Rhode Island law does not mandate a court to adopt the interpretation of a contract put forth by the parties. Docket 3459, Order No. 17524, at page 137 (August 1, 2003). The Commission has further noted that, in its unique role of setting just and reasonable rates for utility service, it must be able to enforce a reasonable interpretation of its order and the accompanying settlement in order to protect the public interest. Id.

In this case, the Company respectfully submits that a reasonable interpretation of the Rate Settlement provisions is to allow the operation of the ESM and the sharing of earnings generated during FY2003.<sup>1</sup> For the reasons set forth below, this finding would best serve the public interest now and in the future.

## III. Language of the Rate Settlement and Commission Order

As noted above, there are two relevant provisions of the Rate Settlement relating to the ESM and the SQP. The express language of those provisions establish the following:

- The ESM is intended to provide the Company with the **incentive to maximize merger-related savings** for the benefit of the Company and its customers;
- The ESM is designed to **provide for the sharing of net merger-related savings** achieved in excess of the revenue requirement built into base rates;

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<sup>1</sup> It should be noted that, at the hearing held on October 30, 2003, the Division of Public Utilities and Carriers stated to the Commission that it believes the terms of the Rate Settlement relating to the ESM and SQP have been fulfilled and that the ESM should be operative.

- The ESM is in place for the period July 1, 2002 through June 30, 2010;
- The **quality of service experienced by customers** is an important factor in consolidating the Company's operations (which is necessary to achieve merger-related savings);
- The Company was obligated to **develop and implement** an SQP in coordination with the Division;
- The Company was obligated to file the SQP with the Commission **no later than September 30, 2002**;
- The Company's **ability to participate in the ESM [is] linked to the establishment of the Service Quality Plan.**

These statements from the Rate Settlement are important because they convey the purpose and intent underlying the Rate Settlement and the Commission's approval of that settlement. As pointed out by the Commission's Counsel, it is the interpretation of the phrase "establishment of the Service Quality Plan" that is at the heart of the issue.

In that regard, the provisions of the Rate Settlement have the effect of: (1) locking into base rates projected operations and maintenance expense savings, which effectively lowered rates for customers by approximately \$2 million per year; and (2) creating a mechanism to allow for sharing between the Company and customers of any actual (excess) savings that may be achieved in the future. As noted above, the Rate Settlement states that the achievement of merger-related savings is a benefit to customers and that allowing the Company to share in any excess earnings will act as an incentive to the Company to maximize those savings. On this point, the Commission's Order states that "[i]n the area of ESM, it is apparent that the Final Amended Settlement for NEGas is in the best interests of the ratepayers. Order at 64 (emphasis added).

Second, the provisions of the Rate Settlement state that the "quality of service experienced by customers" is an important factor in consolidating the Company's operations. Therefore, the Company is directed to "develop and implement" an SQP with the Division, and to file that SQP no later than September 30, 2002, for approval by the Commission. These statements convey the principle that, under the Rate Settlement, the Company is given the "incentive to maximize merger-related savings," and therefore, it is necessary to ensure that the "service quality experienced by customers" does not decline as a result of the Company's efforts to maximize merger-related savings through consolidation. These statements create an inextricable link between the achievement of excess earnings and the level of service quality provided to customers during the time period in which the excess earnings were achieved. These statements do not create an inextricable link between the achievement of excess earnings and the approval of the SQP by the Commission.

This point is underscored by the language used in the Commission's Order approving the Rate Settlement, which states that:

As for service quality, the Final Amended Settlement for NEGas lacks a SQP and the Commission expressed concern over this deficiency. The parties addressed this issue by committing to file, in the near future, a SQP with penalties that will link NEGas' participation in the ESM to **the quality of service**.

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The following modifications to the Amended Settlement are hereby approved:

- a. New England Gas Company will file, no later than September 30, 2002, a proposed Service Quality Plan that will link New England Gas Company's **quality of service** to its ability to participate in the earnings sharing mechanism.

Order at 64 and 67, respectively. These two passages strongly support the interpretation that the development and implementation of an SQP that would measure the quality of service provided to customers during the time period that the Company was working to achieve excess earnings would create the "link" between the ESM and the SQP.

In that regard, it is significant that the SQP filed by the Company on September 30, 2002 was approved by the Commission without modification to the performance measures or the measurement methodologies proposed by the Company.<sup>2</sup> This means that, as of July 1, 2002, the Company was measuring and monitoring service quality in all areas required by the Commission in its approval on June 30, 2003. The Company has previously provided the service-quality performance data for the period July 1, 2002 through May 31, 2003, as well as historical data for periods prior to FY2003, to the Commission. This data shows that the Company's performance in FY2003 was its best performance in any time period for which data has been recorded.<sup>3</sup>

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<sup>2</sup> It is also significant that the September 30, 2002 deadline was set to allow the Division and the Company to conclude their work on the plan that, as of the date of the Commission's bench decision in May 2002, primarily involved the development of a penalty/offset mechanism and not the identification of the performance measures or tracking and monitoring requirements. By July 1, 2002, the Company and the Division had reached agreement on the performance measures and the Company was collecting service-quality data in accordance with those measures.

<sup>3</sup> For the record, the Company has provided as Appendix 1 the service-quality performance data recorded for the period July 1, 2002 through June 30, 2003 (FY2003).

During its consideration of the SQP presented by the Company, the Commission did not indicate any concerns with the quality of service provided to customers during FY2003, nor has the Commission indicated any such concern in this docket. Moreover, there is no language in the Rate Settlement or the Commission's order approving the Rate Settlement indicating that the "establishment of the Service Quality Plan," is synonymous with the Commission's approval of the SQP.

Conversely, the language of the Rate Settlement and the Commission's Order provide ample and reasonable support for the proposition that the Company's participation in the ESM is linked to the quality of service provided to customers during FY2003. This means that the implementation of the SQP would constitute its establishment for purposes of determining whether the Company is able to participate in the ESM. The implementation of the SQP as of July 1, 2002 ensured that the quality of service to customers was tracked and monitored during FY2003, and the record shows that customers received a level of service higher than historical levels in this time period.

Given the Commission's finding that "[i]n the area of ESM, it is apparent that the Final Amended Settlement for NEGas is in the best interests of the ratepayers," the public interest will be served in this case by an interpretation that allows the ESM to operate as anticipated in the Rate Settlement.

#### **IV. POLICY CONSIDERATIONS**

##### **A. ESM and SQP**

The outcome of this inquiry is critical because it will determine the level of investment that the Company can and will make in the future in order to achieve cost reductions and service-quality improvements for customers. This is because a decision by the Commission to deny the Company's participation in the ESM for FY2003 will effectively eliminate a source of capital to fund future efficiency and service improvements and remove the Company's incentive to invest other capital resources in system integrations.

As the Company discussed in its testimony for the base-rate proceeding, it takes investment to streamline operations and achieve cost reductions. The Company has made a number of investments to streamline operations and improve service quality. Just one example of this investment is the merger-related cost reductions that the Company has achieved largely through the integration of information systems and the use of those integrated systems in the place of more expensive human resources. For example, the record in this proceeding shows that the Company invested a total of \$1,736,594 during FY2003 to consolidate certain financial and customer-service systems. See, Response to DIV 3-03. The record also shows a significant decline in O&M expense in FY2003 as a result of staffing reductions achieved through attrition. See, Attachment to DIV 1-01, at page 325. These O&M savings are available, in part, as a result of the integration of the redundant information systems, which allowed the Company to reduce

the staffing levels required to operate separate systems and to manually integrate the reports generated by these systems. These cost reductions are significant and are just one example of the investment that the Company has made to reduce costs for the benefit of customers through the ESM.

As a result, the Company's investment in the system cannot be fairly separated from the increased earnings that are generated as a result of this investment. If the Commission interprets the Rate Settlement so as to preclude the operation of the ESM, the Company's incentive (and ability) to continue making investments in the system will be diminished, and in the future, the availability of excess earnings for customers will decline. This would effectively negate the very purpose and intent of the ESM, as set forth in the Rate Settlement, and therefore, would not serve the public interest.

Lastly, a decision by the Commission to allow the operation of the ESM based on the implementation date of the SQP is consistent with the ESM/SQP framework established for other utilities in Rhode Island. Specifically, for Narragansett Electric Company, the Commission approved a Settlement Agreement in Docket 2930 that involves the application of Service Quality Standards. If, during the period when the Service Quality Standards are in effect, there is a "significant and persistent" deterioration in service quality, the penalties are doubled and the Company is required to file a remedial plan. Narragansett Electric Settlement Agreement, Docket 2930, at page 37-38. The utility's participation in the sharing of merger savings is affected only if after one year, the utility fails to remediate the problem, and is affected only until such time as "service quality" has returned to the levels that existed prior to the merger. To determine that the ESM is not in place in a year where service quality exceeded historical levels is unjustified and not on balance with treatment afforded other utilities operating in the state.

#### B. ESM and Incentive Compensation for Employees

Although the Commission has ordered the Company to base the calculation of the interim DAC on the schedule presented by the Division (Schedule DJE-2S), the cost of incentive compensation, which is paid to employees only when they achieve the objective of increasing earnings or meeting other customer-service goals, is fairly included as an operating cost in the calculation of excess earnings. The Company's earnings sharing calculation included \$244,190 for the allocation of incentive compensation from Southern Union (which was also included in the base rates set in Docket 3401) and \$372,223 for payments to non-union, non-executive employees at New England Gas Company.

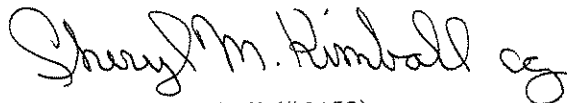
These are appropriate for inclusion in the earnings-sharing calculation because the exclusion of these costs in the past was entirely based on the Commission's finding that the performance objectives of the plan included criteria that benefited shareholders. Docket 2286, Order No. 14859, at 45. The shareholder objectives cited by the Commission were "net income" and "rate of return." Id. However, in Docket 2286, the Commission was engaged in a

Luly Massaro, Commission Clerk  
November 14, 2003  
Page 8

traditional ratesetting process that did not involve the establishment of an earnings-sharing mechanism that is designed to funnel excess earnings to customers. The Commission's stated rationale for excluding the costs was that the performance objectives of increasing net income and the rate of return provided a benefit to shareholders, but not to customers. Id. As recognized by the Commission customers directly benefit from increased earnings and rate of return with the ESM in place. Therefore, unlike the situation in Docket 2286, all of the goals of the Company's incentive compensation plan have a benefit for customers, and therefore, the full cost of the incentive compensation plan should be included in the ESM calculation. See also Rebuttal Testimony of Robert J. Riccitelli, Docket 3548; Company's Response to RR 1-12.

The Company appreciates this opportunity to comment on the outstanding issues in this case. Thank you for your attention and consideration of these issues.

Sincerely,

A handwritten signature in cursive script that reads "Cheryl M. Kimball" followed by a small flourish.

Cheryl M. Kimball (#6458)



MEASUREMENT	Jul-02	Aug-02	Sep-02	Oct-02	Nov-02	Dec-02	Jan-03	Feb-03	Mar-03	Apr-03	May-03	Jun-03	12 Month Weighted Average
<b>CALL CENTER</b>													
Total Calls Answered	44,996	42,950	42,389	57,959	39,806	42,451	50,536	41,237	47,348	50,495	54,924	52,600	567,691
Abandoned Calls	1,402	2,189	2,340	5,114	3,014	1,425	1,658	1,731	1,694	4,444	4,655	4,340	35,006
Total Calls Offered	46,398	45,139	44,729	64,073	42,820	43,876	52,194	42,968	49,042	54,939	59,579	56,940	602,697
% Abandoned Calls	3.0%	4.8%	5.2%	9.5%	7.0%	3.2%	3.2%	4.0%	3.5%	8.1%	7.8%	7.6%	5.81%
Answered in 60 Sec.	43,731	37,556	36,013	42,402	31,416	36,881	44,078	34,335	41,580	38,334	41,490	40,174	488,990
Calls Answered in 60 Sec. Including Automation	94.3%	83.2%	80.5%	66.2%	73.4%	84.1%	84.5%	79.9%	84.8%	71.6%	69.6%	70.6%	77.82%
<b>METER READS</b>													
SCHEDULED METERS METERS READ	220,174	229,583	233,771	225,210	190,992	236,289	224,791	229,576	246,428	228,698	239,426	233,989	2,738,327
% On-Cycle Meter Reads	210,271	218,030	221,017	213,830	185,273	220,217	213,491	217,494	229,648	216,286	225,498	221,948	2,592,941
	95.5%	95.0%	94.5%	94.9%	97.3%	93.2%	95.0%	94.7%	93.2%	94.6%	94.2%	94.9%	94.69%
<b>METER TESTING</b>													
< 300 Cfh	1184	1082	578	498	196	52	305	768	564	1,981	1,623	1,831	10,662
> 300 Cfh	69	50	96	63	16	13	52	71	130	89	80	93	822
Customer requested tests	7	20	17	11	13	14	14	24	27	13	9	15	184
Tests Completed in 15 days	7	20	17	11	13	14	14	24	27	13	9	15	184
% Completed in 15 days	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.00%
<b>SERVICE APPOINTMENTS</b>													
Scheduled service appointments Completed service appointments	5,935	8,055	6,237	7,324	5,085	4,290	5,377	4,734	5,696	7,103	5,636	7,195	72,667
% Service Appointments Met	5,887	7,936	6,170	7,027	4,955	4,115	5,250	4,629	5,550	6,756	5,523	6,865	70,663
	99.2%	98.5%	98.9%	95.9%	97.4%	95.9%	97.6%	97.8%	97.4%	95.1%	98.0%	95.4%	97.24%
<b>SAFETY</b>													
<b>Leak-Call Response</b>													
Normal Business Hours	356	493	489	926	728	638	784	666	552	605	509	436	7,162
- Total calls	306	458	432	818	648	544	702	594	513	554	471	404	6,444
- response in 30 min or less % in 30 min or less	86.0%	92.9%	92.1%	88.3%	89.0%	85.3%	89.5%	89.2%	92.9%	91.6%	92.5%	92.7%	89.97%
After Business Hours	221	361	314	634	510	588	647	544	478	379	357	336	5,369
- Total calls	192	329	300	549	454	527	582	480	434	346	331	318	4,842
- response in 45 min or less % in 45 min or less	86.9%	91.1%	95.5%	86.5%	89.0%	89.6%	90.0%	88.2%	90.8%	91.3%	92.7%	94.6%	90.18%