STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

BEFORE THE PUBLIC UTILITIES COMMISSION

IN THE MATTER OF	)	
INTERSTATE NAVIGATION COMPANY	)	Docket No. 3573
GENERAL RATE FILING	)	

DIRECT TESTIMONY OF

ANDREA C. CRANE

ON BEHALF OF

THE DIVISION OF PUBLIC UTILITIES AND CARRIERS

March 26, 2004

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1 **I.** **STATEMENT OF QUALIFICATIONS**

2 **Q.** **Please state your name and business address.**

3 A My name is Andrea C. Crane and my business address is 38C Grove Street,

4 Ridgefield, Connecticut 06877.

5

6 **Q.** **By whom are you employed and in what capacity?**

7 A. I am Vice President of The Columbia Group, Inc., a financial consulting firm that

8 specializes in utility regulation. In this capacity, I analyze rate filings, prepare expert

9 testimony, and undertake various financial studies regarding utility rates and

10 regulatory policy. I have held several positions of increasing responsibility since I

11 joined The Columbia Group, Inc. in January 1989.

12

13 **Q.** **Please summarize your professional experience in the utility industry.**

14 A. Prior to my association with The Columbia Group, Inc., I held the position of

15 Economic Policy and Analysis Staff Manager for GTE Service Corporation, from

16 December 1987 to January 1989. From June 1982 to September 1987, I was

17 employed by various Bell Atlantic (now Verizon) subsidiaries. While at Bell

18 Atlantic, I held assignments in the Product Management, Treasury, and Regulatory

19 Departments.

20

1 **Q. Have you previously testified in regulatory proceedings?**

2 A. Yes, since joining The Columbia Group, Inc., I have testified in over 165 regulatory
3 proceedings in the states of Arizona, Arkansas, Connecticut, Delaware, Hawaii,
4 Kansas, Maryland, New Jersey, New Mexico, New York, Oklahoma, Pennsylvania,
5 Rhode Island, South Carolina, Vermont, West Virginia and the District of Columbia.
6 These proceedings involved gas, electric, telephone, water, wastewater, solid waste,
7 cable television, and navigation utilities. A list of dockets in which I have filed
8 testimony is included in Appendix A.

9

10 **Q. What is your educational background?**

11 A. I received a Masters degree in Business Administration, with a concentration in
12 Finance, from Temple University in Philadelphia, Pennsylvania. My undergraduate
13 degree is a B.A. in Chemistry from Temple University.

14

15 II. PURPOSE OF TESTIMONY

16 **Q. What is the purpose of your testimony?**

17 A. On or about December 1, 2003, Interstate Navigation Company ("Interstate" or
18 "Company") filed an application with the Rhode Island Public Utilities Commission
19 ("PUC" or "Commission") requesting a rate increase of $2.75 million or
20 approximately 40% over pro forma operating revenues. The Columbia Group, Inc.
21 was engaged by the Rhode Island Division of Public Utilities and Carriers
22 ("Division") to review the Company's rate filing and to develop recommendations

for consideration by the Commission in the areas of revenue requirements and cost of capital. Testimony on rate design issues is being filed on behalf of the Division by Dr. John Stutz.

In developing my recommendations, I reviewed the testimony and exhibits of the Company, and the responses to data requests propounded upon the Company by the Division and the Staff of the Commission. I also reviewed documents from prior cases and other information that was helpful in my analysis of Interstate's Application.

III. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

Q. What are your conclusions and recommendations concerning the Company's pro forma income, rate base, and revenue requirement?

A. Based on my analysis of the Company's filing, on its responses to data requests, and on my experience in utility rate proceedings, my conclusions and recommendations are as follows:

1. The Company has a cost of equity of 10.0% and an overall required rate of return of 7.33% (see Schedule ACC-2).
2. The Company has a pro forma Rate Year (ending May 31, 2005) rate base of $9,366,404 (see Schedule ACC-3).
3. The Company has a pro forma Rate Year (ending May 31, 2005) operating income at present rates of $98,350 (see Schedule ACC-4).
4. Based on these determinations, a revenue requirement increase of $902,951is

1 appropriate. This is in contrast to the revenue requirement increase of
2 $2,750,712 requested by the Company (see Schedule ACC-1).
3 5. The provision of goods and services from related companies to Interstate should
4 be priced at the lower of cost or market value.
5
6 **IV. OVERALL RATE OF RETURN**
7 **Q. What is the cost of capital and capital structure that the Company is requesting**
8 **in this case?**
9 A. As shown on Schedule WEE-17 to Mr. Edge's testimony, the Company has utilized
10 the following capital structure and cost of capital:

	Amount	Percent	Cost	Weighted Cost
LDT-Phase1	$2,000,000	13.30%	6.1%	0.81%
LDT-Phase 2	$2,000,000	13.30%	7.0%	0.93%
LDT-Phase 3	$2,307,947	15.35%	7.5%	1.15%
New Debt-Anna C	$2,000,000	13.30%	6.4%	0.85%
New Debt-Carol Jean	$2,600,000	17.30%	6.4%	1.11%
Common Equity	$4,125,242	27.44%	11.5%	3.16%
Total	$15,033,189	100.00%		8.01%

11
12
13 **Q. How did the Company determine its capital structure?**

1 A. As shown on Schedule WEE-17 to Mr. Edge's testimony, the Company included
2 existing long-term debt of $6,307,947, proposed new debt of $4,600,000, and test
3 year equity of $4,125,242. The existing long-term debt was originally incurred in
4 the amount of $6,333,098[1]. $2 million of this loan was converted into a fixed rate at
5 6.1% while the remainder of the loan is at a variable rate. In the response to DIV 1-
6 43, the Company indicated that the variable rate was at 3.25%. The variable rate is
7 based on prime less 100 basis points, as stated on Schedule WEE-17. Therefore, the
8 variable interest rate should now be 3.00%, since the prime rate was reduced to 4.0%
9 effective June 27, 2003.
10 Interstate reflected fixed rates of 7.0% and 7.5% in its filing, claiming that it
11 intended to convert $2 million of the variable rate debt to a fixed rate when long-
12 term rates reached 7.0% and to convert the remainder when long-term rates reached
13 7.5%.[2] The Company also included two new debt issuances, one in the amount of
14 $2 million to finance the re-powering of the MV Carol Jean and one in the amount of
15 $2.6 million to finance the purchase of the MV Anna C. The Company assumed
16 that these debt issuances would be at a rate of 6.4%, which Interstate claimed was the
17 current fixed rate offered by Washington Trust at the time it prepared its testimony[3].
18 Finally, Interstate included equity of $4,125,242, which it stated represents no gain
19 or loss in the interim year.
20

1 Response to DIV 1-43.
2 Response to DIV 1-42.
3 Response to DIV 1-44.

1 **Q. Have you made any adjustments to the Company's capital structure?**

2 A. I have made one adjustment to the capital structure proposed by the Company. First,
3 as discussed below, I am recommending that that the Company's claim to include the
4 MV Anna C. in rate base at a market price of $3.1 million be denied. Accordingly, I
5 have eliminated the proposed $2.6 million debt issuance for the MV Anna C. that the
6 Company indicated was necessary to purchase this vessel. My adjusted capital
7 structure is shown in Schedule ACC-2.

8

9 **Q. What cost of debt did you use in developing your rate of return**
10 **recommendation?**

11 A. With regard to the existing fixed rate debt, I used the debt costs contained in Mr.
12 Edge's testimony at Schedule WEE-17. With regard to the existing variable debt, I
13 used a rate of 5.98%. I understand that Mr. Edge notified the Division on March 9,
14 2004, that Interstate now plans to convert both of these variable issuances into fixed
15 rate debt at a rate of 5.98%. Therefore, I have used the 5.98% to develop the
16 Company's overall cost of capital. Moreover, I have also used a cost rate of 5.98%
17 for the new debt related to the re-powering the MV Carol Jean. Since the Company
18 has indicated that it can obtain this fixed rate when it converts its existing variable
19 cost debt, then it is reasonable to assume that it can also obtain new debt for re-
20 powering the MV Carol Jean at the same rate.

21

22 **Q. What cost of equity are you recommending for Interstate?**

1 A. I am recommending a cost of equity of 10.0%.

2

3 **Q. What is the basis for your cost of equity recommendation?**

4 A. In order to develop a cost of equity recommendation, I have utilized two financial

5 models: the Discounted Cash Flow ("DCF") methodology and the Capital Asset

6 Pricing Model ("CAPM"). Although I have analyzed the Company's cost of equity

7 under both of these methodologies, I gave the greatest consideration to the cost of

8 equity that resulted from the DCF methodology, which this Commission has

9 traditionally relied upon to develop an appropriate cost of equity for utility

10 companies. In addition, the DCF analysis is the most frequently used method to

11 determine an appropriate return on equity for a regulated utility.

12

13 **Q. Please describe the DCF methodology.**

14 A. The DCF methodology equates a utility's return on equity to the expected dividend

15 yield plus expected future growth for comparable investments. Specifically, this

16 methodology is based on the following formula:

17–18

$$\text{Return on Equity} = \frac{D_1}{P_0} + g$$

19 where "D_1" is the expected dividend, "P" is the current stock price, and "g" is the

20 expected growth in dividends.

21 To determine the appropriate return on equity for Interstate, I began with a

22 proxy group consisting of regulated water utilities. My proxy group consisted of the

1 five, small to mid-cap, water utilities followed by the Value Line Investment Survey,
2 a research organization commonly used by financial analysts to review financial
3 data. My first step was to develop an appropriate dividend yield for the proxy
4 group. To determine the average dividend yield, I used the current dividend for
5 each company and the average of the high and low stock prices over the past six
6 months. The use of the average high and low stock price over a six-month period
7 helps to mitigate fluctuations in stock prices that occur from day-to-day.
8 This analysis resulted in an average divided yield of 2.87% for the proxy group,
9 as shown in Schedule ACC-2A. I checked this yield against a recent dividend yield,
10 using stock prices as of March 5, 2004. This resulted in a dividend yield of 2.70%,
11 as also shown in Schedule ACC-2A. In addition, I checked this dividend yield
12 against the most recent yield reported in the C.A. Turner Utility Reports for Water
13 Companies. According to the March 2004 Report, the average yield for the water
14 companies followed by C.A. Turner was 2.8%. Based on my review of this data, I
15 believe that a dividend yield of no greater than 3.0% is appropriate for use in the
16 DCF model.
17 The next step was to examine the expected growth rate. The actual growth
18 rate used in the DCF analysis is dividend growth rate. In spite of the fact that the
19 model is based on dividend growth, it is not uncommon for analysts to examine
20 several growth factors, including growth in earnings, dividends, and book value.
21 Since these small to mid-cap water utilities are not as actively followed by
22 security analysts as larger water utilities, the availability of both historic and

1 projected date is limited. Based on readily available data, however, I have identified

2 the following average historic and projected growth rates:

3

	Five Year Historic Earnings	Five Year Historic Dividends	Five Year Historic Book Value	Five Year Projected Earnings
Connecticut Water Company	2.50%	1.00%	3.50%	NA
Middlesex Water Company	-0.50%	2.50%	4.00%	7.00%
SJW Corporation	-2.00%	3.50%	5.50%	NA
Southwest Water Corporation	10.50%	10.00%	9.50%	9.00%
York Water Company	NA	NA	NA	7.00%
Average	2.63%	4.25%	5.63%	7.67%

4

5

6 **Q. Based upon your review, what growth rate do you recommend be utilized in the**

7 **DCF calculation?**

8 A. Based on my review of this data, I believe that a growth rate of no greater than 6.0%

9 should be utilized. This growth rate is higher than the actual growth rates over the

10 past five years in earnings, dividends, or book value. While the average projected

11 earnings forecast is somewhat higher than 6.0%, forecasted earnings growth rates

12 tend to be overly optimistic.

1 **Q. Why do you believe that earnings forecasts tend to be overly optimistic?**

2 A. Analysts have been notoriously optimistic in forecasting future growth in earnings.
3 At least part of this problem in the past has been the fact that firms that traditionally
4 sell securities are the same firms that provide investors with research on these
5 securities, including forecasts of earnings growth. This results in a direct conflict of
6 interest since it has traditionally been in the best interest of securities firms to
7 provide optimistic earnings forecasts in the hope of selling more stock. As a result
8 of this practice, the Wall Street investment firms agreed to a $1.4 billion settlement
9 with securities regulators in a settlement announced last year. Pursuant to that
10 settlement, ten major Wall Street law firms agreed to pay $1.4 billion to investigating
11 state regulators and the United States Securities and Exchange Commission ("SEC").
12 Approximately $900 million of this amount constituted fines. The remainder was
13 earmarked for various education and independent research activities. In addition,
14 firms were required to sever the links between their stock research activities and their
15 investment banking activities. Therefore, earnings growth forecasts should be
16 analyzed cautiously by state regulatory commissions.
17

18 **Q. What are the results of your analysis?**

19 A. Prior to any adjustment, my analysis indicates a cost of equity using the DCF
20 methodology of 9.00%, as shown below:
21

Dividend Yield	3.00%
Expected Growth	6.00%
Total	9.00%

Q. Did you also calculate a cost of equity based on the CAPM methodology?

A. Yes, I did.

Q. Please provide a brief description of the CAPM methodology.

A. The CAPM methodology is based on the following formula:

Cost of Equity = Risk Free Rate + Beta (Risk Premium)

or

$$\text{Cost of Equity} = R_f + B(R_m - R_f)$$

The CAPM methodology assumes that the cost of equity is equal to a risk-free rate plus some market-adjusted risk premium. The risk premium is adjusted by Beta, which is a measure of the extent to which an investor can diversify his market risk. The ability to diversity market risk is a measure of the extent to which a particular stock's price changes with changes in the overall stock market. Thus, a Beta of 1.00 means that changes in the price of a particular stock can be fully explained by changes in the overall market. A stock with a Beta of 0.60 will exhibit

1 price changes that are only 60% as great as the price changes experienced by the
2 overall market. Utility stocks have traditionally been less volatile than the overall
3 market, i.e., their stock prices do not fluctuate as significantly as the market as a
4 whole.
5
6 **Q. How did you calculate the cost of equity using the CAPM?**
7 A. First, I used a risk free rate of 5.00% for the yield on long-term U.S. Government
8 bonds. Since January 1, 2004, this rate has ranged from 5.01% to 4.67%. I used the
9 average Beta for my proxy group as reported by Value Line, which was 0.57.
10 Finally, since I am using a long-term U.S. Government bond rate as the risk-free
11 rate, the risk premium that should be used is the historic risk premium of small
12 company stocks over the rates for long-term government bonds. According to the
13 2003 Ibbotson Associates' publication, *2003 Handbook: Stocks, Bonds, Bills, and*
14 *Inflation*, the geometric risk premium of small company stocks relative to long-term
15 risk-free rates using geometric mean returns is 6.6%. Accordingly, I have used 6.6%
16 as the risk premium in the development of the cost of capital based on the CAPM
17 methodology.
18
19 **Q. What is the Company's cost of equity using a CAPM approach?**
20 A. Given a long-term risk-free rate of 5.00%, a Beta of 0.57, and a risk premium of
21 6.6%, the CAPM methodology produces a cost of equity of 8.76%, as shown on
22 Schedule ACC-2A.

Q. What cost of equity are you recommending in this case?

A. The CAPM methodology and the DCF methodology suggest that a return on equity of 8.76% to 9.00% would be appropriate. However, since Interstate is generally a smaller company than the companies used in my proxy group, I am recommending a small company premium of 75 basis points. This is the same small company premium that I recommended in the Company's last base rate case. This would result in a cost of equity of 9.51% to 9.75% pursuant to the CAPM and DCF methodologies respectively. Given that fact that Interstate has somewhat more risk than it had in the last base rate case, I am recommending a cost of equity of 10.0% for the Company. This recommendation is 125 basis points below my cost of equity recommendation in the Company's last base rate case.

Q. Please comment on Mr. Edge's contention that a return on equity of 11.5% is appropriate because the Commission approved a similar return in the Company's last base rate case.

A. The fact that a return on equity of 11.5% was specified in the stipulation in the Company's last case does not mean that it should be adopted by the Commission in this case, for several reasons. First, the Company's last base rate case was resolved by stipulation. In that stipulation, the parties agreed to specify a return on equity of 11.5%. However, in any stipulation, there are a number of trade-offs that occur among the parties. For the most part, the parties to a stipulation are more concerned

about the overall result than about any single element of the stipulation. Moreover, while the Commission approved the stipulation in that case, the Commission did not independently develop an appropriate return on equity for Interstate. Rather, the Commission approved the stipulation, most likely on the basis that the end result was a reasonable one.

Second, since the Company's last base rate case was resolved by stipulation in March 1997, seven years ago, interest rates have fallen dramatically. For example, in March 1997, the prime rate was 8.5%. Today, the prime rate is 4.0%. Therefore, one could conclude that capital costs today are only 50% of capital costs at the time of the Company's last base rate case. Moreover, since the last case, the six-month constant maturity Treasury rate has declined from 5.39% in 1997 to 1.0% today, while the twenty-year constant maturity Treasury rate has declined from 7.05% to 4.67%. Given these dramatic declines, it is clear that the 11.5% agreed to by the parties in the Company's last case is excessive in today's financial markets, and Mr. Edge's cost of equity claim should therefore be rejected.

Q. What is the overall cost of capital that you are recommending for Interstate?

A. I am recommending an overall cost of capital of 7.33%, as shown below:

	Percent	Cost	Weighted Cost
Common Equity	33.18%	10.00%	3.32%
Long-Term Debt:			
Phase 1	16.09%	6.10%	0.98%
Phase 2	16.09%	5.98%	0.96%
Phase 3	18.56%	5.98%	1.11%
Loan for Carol Jean	16.09%	5.98%	0.96%
Total			7.33%

V. RATE BASE ISSUES

Q. How did the Company develop its rate base claim in this case?

A. Interstate used the twelve months ending May 31, 2003 as the Test Year in this case. The Rate Year is the twelve-month period ending May 31, 2005. The twelve months ending May 31, 2004 is referred to by the Company as the Interim Year.

In order to develop its rate base claim, the Company first examined actual net utility plant balances at May 31, 2003. It then added Interim Year additions of $913,134. These additions include a bulkhead at Block Island, a ramp at Block Island, the purchase of a truck and forklift, and a dredging project at Montville. Interstate also included Rate Year Additions of $6,506,223, consisting of $3.1 million for the purchase of the MV Anna C., $3.0 million for re-powering and

upgrade of the MV Carol Jean, $136,233 for upgrade of the Company's computer ticketing system, and $270,000 for completion of the Point Judith project.

Interstate also included additions to its depreciation reserve for both the Interim Year and for the Rate Year. The Company determined its average Rate Year plant balance by taking the average of the projected net plant balances at the beginning and end of the Rate Year. To its average Rate Year net plant balance, Interstate then added a working capital claim of $655,054.

Q. What adjustments are you recommending to the Company's rate base claim?

A. I am recommending adjustments to the Company's claims for dredging at Montville, for purchase of the MV Anna C., and for cash working capital.

A. <u>Plant in Service Additions</u>

Q. Are you recommending any Interim Year adjustments to the Company's utility plant in service claim?

A. Yes, I am recommending that the Company's claim be reduced to limit amounts for the Montville dredging project to actual expenditures already made. The Company included $200,000 in its Interim Year plant additions associated with this project. In response to DIV 1-45, the Company indicated that the estimated cost for this project was "made by Interstate based upon 30 plus years of experience with these types of expenditures." The Company did not provide any third-party bids or any other documentation to support this claim. Moreover, the Company has spent only

1 $23,049 on this project to date, according to the response to DIV 1-46. This project
2 was started in September 2000, over 3 ½ years ago. Although the Company started
3 this project 3 ½ years ago, it does not appear that much progress has been made,
4 given the relatively low expenditures relative to the Company's projections. Nor has
5 Interstate provided any documentation showing that it is moving forward with this
6 project, or that its Rate Year expenditure projection is reasonable. For all these
7 reasons, I recommend that the Commission limit the cost of this project that is
8 included in rate base to the expenditures already made. My adjustment is shown in
9 Schedule ACC- 6.
10
11 **Q. Are you recommending any other adjustments to the Interim Year plant-in-**
12 **service claims?**
13 A. No, I am not. The Company has completed the other Interim Year projects, except
14 for purchase of the forklift. At this time, I am recommending that the forklift be
15 included in rate base, since that equipment can be acquired in a relatively short
16 period of time. Interstate stated in response to DIV 1-46 that it expected to acquire
17 the forklift in March 2004. At this time, I do not know if the forklift has, as yet, been
18 acquired. The Company should provide us with an update during the hearing phase
19 of this case regarding its progress in acquiring the forklift. If it appears that
20 Interstate is no longer pursuing acquisition of this equipment, then I would
21 recommend another rate base adjustment to eliminate the forklift from the
22 Company's claim.

1

2 **Q. What adjustment are you recommending to the Company's claim for Rate Year**
3 **plant-in-service additions?**

4 A. I am recommending one adjustment, relating to the MV Anna C. The Company is
5 proposing to purchase the MV Anna C from its affiliate, Nelseco Navigation
6 Company ("Nelseco"), at a cost of $3.1 million. Mr. Edge claims that this amount
7 reflects the market value of the MV Anna C based on an appraisal conducted on
8 behalf of Interstate.

9

10 **Q. Does the Company currently use the MV Anna C in its operations?**

11 A. Yes, Interstate currently leases the MV Anna C. on a daily or half-day basis. In
12 fiscal year 2003, the Company leased the MV Anna C for 57 full days and for 54
13 half-days, per the response to DIV 1-21.

14

15 **Q. Does this lease arrangement constitute an affiliate interest transaction?**

16 A. Yes, it does. An affiliated interest transaction is a transaction between two entities
17 that share common ownership or control. The MV Anna C. is currently owned by
18 Nelseco, an affiliate of Interstate. Susan Linda, the President of Interstate, is also
19 the President of Nelseco. In addition, Mrs. Linda signed the current rental
20 agreement for the MV Anna C. on behalf of both Nelseco and Interstate. Clearly,
21 the current lease arrangement constitutes an affiliated interest transaction, as would
22 the purchase of the MV Anna C. from Nelseco by Interstate.

1

2 **Q. Should affiliated interest transactions be subject to greater regulatory scrutiny**
3 **than transactions between non-affiliated parties?**

4 A. Yes, they should. Transactions between non-affiliated parties are conducted at
5 "arm's length." They are generally the result of a negotiation or bidding process, or
6 they reflect prices that are available to the public. With non-affiliated transactions,
7 each party has an incentive to make the best possible arrangement, and neither party
8 has an incentive to subsidize the other. Such safeguards are not present with
9 affiliated interest transactions.

10

11 **Q. What regulatory standards should be used to evaluate affiliated interest**
12 **transactions from an affiliate to a regulated entity for ratemaking purposes?**

13 A. Affiliated interest transactions should involve products or services that are
14 necessary for the provision of safe and adequate regulated service. Moreover, the
15 regulated entity should demonstrate that these products or services could not have
16 been obtained at a lower cost from a non-affiliated vendor. It should also
17 demonstrate that these products or services could not have been produced internally
18 or performed by the regulated entity itself at a cost lower than that charged by the
19 affiliate. Finally, the regulated entity should demonstrate that any allocation factors
20 used to allocate affiliated interest transactions, appropriately reflect cost causation.

21

22 **Q. How should affiliated interest transactions be priced?**

1 A. Corporate governance and common support functions are generally charged to all
2 subsidiaries based on fully distributed cost. For other services provided to affiliates,
3 asymmetric pricing should be used for transactions between a regulated entity and a
4 non-regulated affiliate, unless the transactions involve a regulated utility service
5 generally available to third parties at tariffed rates.
6
7 **Q. Please describe the asymmetrical pricing standard.**
8 A. An asymmetrical pricing standard states that goods or services that are provided by a
9 regulated entity to its affiliate should be priced at the higher of cost or market price,
10 while goods and services provided by a non-regulated affiliate to a regulated entity
11 should be priced at the lower of cost or market price. The same standards are also
12 used for asset transfers.
13
14 **Q. Why do you believe that an asymmetrical pricing standard is appropriate?**
15 A. I believe that an asymmetrical pricing standard is appropriate because it provides the
16 greatest protection to ratepayers, and it ensures that regulated ratepayers will never
17 pay rates that are higher than they would have paid if the regulated entity had
18 performed the service for itself, internally. If an affiliate sells a good or service to a
19 regulated entity, the price paid by the regulated entity should not exceed the lower of
20 cost or market. If the price paid by the regulated entity were higher than market
21 price, then the regulated entity would have paid too much, since the same good or
22 service could have been obtained more cheaply in the competitive market. If,

1 however, the affiliate's cost is less than market, then the regulated entity should not
2 pay more than cost. Allowing a regulated entity to recover more than cost, even if
3 the price paid is below market, provides an incentive for the creation of various
4 unregulated entities in order to maximize the amount that can be passed through to
5 regulated ratepayers.
6
7 **Q. Has the National Association of State Regulatory Utility Commissioners**
8 **("NARUC") addressed the issue of affiliated transactions?**
9 A. Yes. At its summer meeting held on July 23, 1999, the NARUC Board of
10 Directors adopted "Guidelines for Cost Allocations and Affiliated
11 Transactions."
12
13 **Q. What specific methodology did NARUC recommend for the pricing of affiliated**
14 **transactions?**
15 A. The NARUC guidelines include an asymmetrical pricing methodology, i.e. the prices
16 for services, products, and the use of assets provided by a regulated entity to its non-
17 regulated affiliate should be priced at the higher of fully allocated costs or prevailing
18 market prices, while the prices for services, products and the use of assets provided by
19 a non-regulated affiliate to a regulated affiliate should be at the lower of fully allocated
20 costs or prevailing market prices.
21

1 **Q. Do you support the NARUC proposals?**

2 A. Yes, I do. The use of an asymmetrical pricing methodology can be an excellent
3 safeguard against cross-subsidization, particularly if accompanied by appropriate PUC
4 oversight. In addition, it ensures that a regulated entity's resources will be utilized in
5 the most efficient manner. For example, asymmetrical pricing ensures that a regulated
6 entity will not provide a product or service to an affiliate at a price that is lower than it
7 could obtain from an unaffiliated third party. It also ensures that it will not pay a price
8 to an affiliate that is higher than the price for which the service or product could be
9 obtained on the open market. Asymmetrical pricing treats affiliates in the same
10 manner as a third party, while at the same time recognizing that a regulated entity's
11 revenue requirement should be based on costs, and that an affiliate should not unduly
12 benefit from costs that are artificially inflated through creative restructuring.

13

14 **Q. In the past, has the Commission recognized that transactions involving the MV**
15 **Anna C. deserve closer scrutiny than other transactions between unaffiliated**
16 **parties?**

17 A. Yes, it has. Although the MV Anna C. was first leased by Interstate prior to the
18 NARUC policy announcement regarding asymmetric pricing, the methodology used to
19 determine the rental rate has been consistent with this policy. The PUC first
20 addressed this issue in Docket No. 1935. In that case, Interstate claimed a per diem
21 rental expense of $2,000 on the basis that the $2,000 represented a market price. I
22 testified in that case, arguing that a lower of cost or market standard should apply.

1 Specifically, I testified that,

2 The standard that I used in determining a fair lease expense for ratemaking
3 purposes was that the cost to Interstate should not be greater than if the utility
4 (Interstate) had provided the service to itself, at the lower of cost or market.[4]
5
6 I also testified in that case that, given certain unique characteristics of that rental
7 agreement, it was not possible to determine a "market price", and therefore I
8 recommended that the per diem rental fee be based on "cost", as "cost" would be
9 determined for a regulated entity. Specifically, I determined a rate base for the vessel
10 and applied an appropriate return to that rate base. I also included applicable costs
11 such as insurance, maintenance expenses, depreciation, and overhead costs. In that
12 testimony, I developed a recommended per diem rental fee of $1,772, which was the
13 per diem fee agreed to by Interstate in the stipulation in that docket. The stipulation
14 was later amended to permit the MV Anna C. to be leased for 243 days at a total
15 annual cost of $300,000, or $1,234 per day.
16
17 **Q. What is the current cost basis for the MV Anna C?**
18 A. According to the response to DIV-1-47, at May 31, 2003, the net book value of the
19 MV Anna C was $371,367.
20
21 **Q. If Interstate proceeds with its plans to purchase the Anna C., what is the**
22 **amount that should be included in rate base?**

4 Testimony of Ms. Crane, Docket No. 1935, page 7.

1 A. The amount that should be included in rate base is the net book value of the MV
2 Anna C. during the Rate Year. Interstate may choose to pay Nelseco an amount that
3 exceeds net book value, but any excess payments should no be included in
4 Interstate's regulated rate base.
5
6 **Q. How did you quantify the rate base value of the MV Anna C.?**
7 A. In response to DIV 1-49, Interstate reported an annual depreciation expense for the
8 Anna C. of $146,152. Therefore, given a net book value of $371,367 at May 31,
9 2003, and annual depreciation expense of $146,152, the net book value of the Anna
10 C. would be $225,215 at the beginning of the Rate Year. This is the Rate Year
11 amount that I recommend be included in the Company's rate base claim in this case.
12 My adjustment is shown in Schedule ACC-7.
13
14 **Q. Why isn't it appropriate to utilize a market price for the MV Anna C. as**
15 **suggested by Interstate?**
16 A. It is not reasonable to utilize a market price because, as discussed above, this is an
17 affiliated interest transaction. Accordingly, a lower of cost or market value should
18 be used. In this case, cost is significantly less than market value. A cost basis has
19 been used in the past for transactions involving the MV Anna C. and the
20 Commission should continue to utilize a cost-basis.
21

1 **Q. If, as a result of your recommendation, Interstate decides not to purchase the**
2 **MV Anna C., would you recommend an adjustment to the rental fee?**
3 A. Yes, I would. If the Company continues to lease the MV Anna C., then the rental fee
4 should be adjusted to reflect the reduction in net book value since the Company's
5 last base rate case. The methodology used to develop the new rental fee should be
6 the same methodology adopted in Docket No. 1935. In addition, if Nelseco provides
7 a crew and incurs other direct expenses associated with the MV Anna C. when it is
8 leased to Interstate, then these costs should also be included in the daily rental fee.
9 Of course, in that case, Interstate's pro forma rate year expenses, which include the
10 impact of owning the MV Anna C., would also have to be adjusted to remove all
11 operating expenses that would no longer be incurred directly by Interstate.
12
13 **B. <u>Reserve for Depreciation</u>**
14 **Q. Are you recommending any adjustments to the Company's claim for**
15 **accumulated depreciation?**
16 A. Yes, I have made adjustments to the Company's accumulated depreciation reserve
17 claim to be consistent with the plant in service recommendations discussed above
18 with regard to the Montville dredging project and the purchase of the MV Anna C.
19 Since I have reduced the Company's claimed plant in service, it is necessary to also
20 reduce the Interim Year and Rate Year depreciation reserve additions. These
21 adjustments are shown in Schedule ACC-8.
22

C. Cash Working Capital

Q. Please describe the Company's cash working capital claim.

A. Interstate included a cash working capital claim of $655,054 in its rate base. This is the cash working capital amount that was included in the stipulation in Docket No. 1935.

Q. What is cash working capital?

A. Cash working capital is the amount of cash that is required by a utility in order to cover cash outflows between the time that revenues are received from customers and the time that expenses must be paid.

Q. Do companies always have a positive cash working capital requirement?

A. No, they do not. The actual amount and timing of cash flows dictate whether or not a utility requires a cash working capital allowance. A lead-lag study is the best method for determining the actual cash working capital requirement for a regulated entity. The cash working capital study examines the actual amount and timing of cash flows and determines whether there is a need for any cash working capital allowance. The Company did not prepare a lead-lag study in this case.

Q. Are you recommending any adjustment to the Company's cash working capital claim?

1 A. Yes, I am recommending that the Company's claim for any cash working capital
2 allowance be denied.
3

4 **Q. What is the basis for you recommendation?**

5 A. My recommendation is based on the fact that the vast majority of the Company's
6 revenues are received in advance of service being provided. I understand that all
7 passenger and vehicles must pay in advance of service being provided. In some
8 cases, payment is received well in advance of service being provided, as stated in the
9 response to COM-17, which addresses pre-sale of group tour passengers and
10 vehicles. In fact, approximately 60% of tour group sales and 70% of vehicles sales in
11 the summer months are presales. In contrast, the Company's largest operating
12 expense is for payroll, which generally has a payment lag of at least 2.5 days. The
13 next largest operating expense is depreciation, which is a non-cash expense and
14 therefore has no cash working capital impact. Fuel expenses must be paid 30 days
15 after delivery, according to the response to COM-31. In fact, a review of the
16 expenses shown in Schedule WEE-7 indicates that the vast majority are the types of
17 costs that have expense lags. In addition, debt service payments generally are paid
18 quarterly or semi-annually, creating another good source of cash working capital.
19 Accordingly, the additional debt that I have included for re-powering the MV Carol
20 Jean will increase the capital working capital provided by interest expense. For all
21 these reasons, there is a definite possibility that the Company has a negative cash
22 working capital requirement.

Q. Doesn't the Company receive most of its revenue in the summer months and therefore isn't there a need for cash working capital in the winter?

A. While it is true that the Company receives most of its revenue in the summer months, the Company's fiscal year begins on June 1st. Therefore, it collects the majority of its revenues early in the fiscal year. Rather than waiting until the summer months to collect the revenues that it needs for the preceding winter, the Company actually collects the revenues that it will need each winter during the preceding summer. Moreover, the Company's expenses are significantly reduced in the winter, especially its payroll expense.

Q. What do you recommend?

A. I recommend that the Company's cash working capital claim be eliminated. At this time, there is no reason to continue to allow the Company to receive a large cash working capital allowance when most of its revenues are received prior to service being provided. In addition, the new interest expense payments will create a new source of cash working capital. My adjustment is shown in Schedule ACC- 9.

D. Summary of Rate Base Adjustments

Q. What is the impact of all of the rate base adjustments that you are recommending?

A. As summarized in Schedule ACC-3, my recommended adjustments reduce the Company's rate base from $11,465,510 to $9,366,404.

VI. OPERATING INCOME ISSUES

A. Pro Forma Revenue

Q. Are you recommending any adjustments to the Company's claim for pro forma operating revenues?

A. Yes, I am recommending an adjustment to the Company's claim for Rate Year passenger revenues.

Q. How did Interstate determine its claim for Rate Year passenger revenues?

A. In its filing, Interstate reflected a reduction in passenger revenues of 8.4% in the Interim Year and an additional reduction of 8.4% in the Rate Year, for a two year reduction totaling $597,000. The 8.4% annual reduction was based on actual data for the summer months of 2003.

Q. Do you believe that the Company's claim is reasonable?

A. No, I do not, for several reasons. First, the weather last summer was very bad, with many rainy weekends. While Mr. Edge did not review actual temperature and rainfall data in developing his pro forma revenue recommendation[5], he acknowledges on page 12, lines 1-3 of his testimony that weather does impact on the amount of revenues received by Interstate. This is not unusual, since revenues for many regulated entities can vary with variations in the weather. In fact, many

5 Response to DIV 1-1.

1 regulatory commissions typically "normalize" revenues in order to mitigate the
2 impact of weather fluctuations from year-to-year. Therefore, the decline in revenues
3 that the Company experienced last summer, and which is reflected in its Interim
4 Year projection, was certainly impacted by unfavorable weather conditions. I
5 understand that in July and August 2003, there were five weekends with at least
6 some rain on Block Island, while there were no weekends with rain during July and
7 August, 2002. In total, Block Island had over 6.12 inches of rain during the months
8 of July and August 2003, while during July and August 2002 rainfall totaled 1.36
9 inches. Clearly, the weather during July and August 2003 played a significant factor
10 in the Company's revenue reductions.

11 In addition, there are other factors that will impact on revenues that have not
12 been considered by Mr. Edge. For example, the purchase of the MV Anna C. should
13 significantly enhance revenues. As discussed by Susan Linda at pages 8-9 of her
14 testimony, the MV Anna C. will replace the MV Nelseco, which is a passenger-only
15 vessel and which has been the subject of complaints by Interstate customers. Re-
16 powering and upgrading the MV Carol Jean should also result in increased revenues.
17 As discussed on page 10, lines 4-6 of Susan Linda's testimony, the Company plans
18 to "finish the interior of the cabin and install air conditioning in the cabin so that we
19 can better compete with the amenities of our competition." The upgrade of the
20 engines in the MV Carol Jean will also enhance the attractiveness of that vessel. In
21 addition, Interstate plans to increase the scope of its advertising program, which

1 should result in additional revenue opportunities. [6]

2

3 **Q. What do you recommend?**

4 A. I recommend that the Commission include Rate Year passenger revenues of

5 $3,552,672 in the Company's revenue requirement. This reflects a reduction of

6 4.2% from the actual Test Year level of revenue. My recommendation is based on

7 the assumption that one-half of the Interim Year decline of 8.4% proposed by Mr.

8 Edge was weather-related and that a "normal" level of Interim Year revenue would

9 have been $3,552,672. Given the purchase of the MV Anna C., the re-powering of

10 the MV Carol Jean, and the expanded advertising program, I am recommending that

11 the Commission reflect no further decline from the Interim Year to the Rate Year.

12 My recommendation is shown in Schedule ACC-10.

13

14 **Q. Are you recommending any other adjustments to the Company's pro forma**

15 **revenue claim?**

16 A. No, I am not. The only adjustment to pro forma revenue at present rates that I am

17 recommending is the adjustment to passenger revenues discussed above.

18

19 **B. <u>Salaries and Wages</u>**

20 **Q. How did the Company develop its salary and wage claim in this case?**

---

6 While the Division is recommending a more modest advertising expenditure in the Rate Year than the amount proposed by Interstate, our recommendation will still permit an expansion of the program relative to the Test Year.

A. As discussed on pages 16-19 of Mr. Edge's Testimony, Interstate increased the actual test year salary and wage expense by 2.5% for the Interim Year, and by another 5.0% for the Rate Year, to reflect payroll increases for existing employees. It also included one new crew position for the MV Anna C, at an annual rate of $30,000. The Company contends that this new position is required "by law and Coast Guard regulation."[7] The Company also included a management increase of $108,901 for increases to Susan Linda, Raymond Linda, and Joshua Linda.

Q. Are you recommending any adjustments to the Company's claim?

A. Yes, I am recommending an adjustment to the Company's claim for management salaries. In this case, Interstate is requesting an increase of over 51% from the Interim Year to the Rate Year for Susan Linda, an increase of over 33% for Raymond Linda, and an increase of over 36% for Joshua Linda. Mr. Edge states that these increases are warranted, because the three managers are currently underpaid relative to executives in other regulated entities and because their work will expand due to oversight of such projects as re-powering of the MV Carol Jean, oversight of the Point Judith project, new homeland security regulations, and other factors.

Mr. Edge has provided no study to support his claim that the salaries for the Linda family members are below market. In fact, in response to DIV 1-14, Mr. Edge acknowledged that he "did not complete a study and has no reports, analysis or

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7 Testimony of Mr. Edge, page 17, lines 21-22.

other documentation of the salary and wages of public utility officers within the State of Rhode Island." In addition, in this case, all three members of the Linda family are also owners of the Company and participate in any profits earned by the Company. It is not unusual in small, family owned companies for the officers to take a smaller salary than what would normally be paid to an independent manager who had no ownership interest.

Moreover, the types of projects that the Linda family will be managing during the Rate Year are not materially different from the types of projects that they have managed in prior years. For example, in the last case, the Company requested authorization to finance a new boat, which was included in rate base. The Point Judith project was also included in rate base in the Company's last base rate case, even though the project has still not been completed. The development of advertising strategies and marketing plans is not a new function either, and in fact Interstate's managers have directed a substantial advertising program for many years. While there may be some new requirements, e.g. homeland security plans, these factors do not justify the magnitude of the salary increases being requested here.

Q. What level of salary increases has the Linda family received over the past few years?

A. Following are the salary increases granted to the Susan Linda, Raymond Linda, and Joshua Linda over the past few years:

1

	Susan Linda	Ray Linda	Josh Linda
1998-1999	4.4%	5.9%	6.0%
1999-2000	2.8%	3.0%	4.1%
2000-2001	3.3%	3.2%	8.1%
2001-2002	8.9%	2.8%	4.1%
2002-Interim	8.8%	8.6%	8.2%

2

3 **(Response to DIV 1-15)**

4 In addition, the Company's claim in this case includes a 5% increase in the Rate
5 Year for all salaries and wage, so the Company's filing already reflects a 5% Rate
6 Year increase for the Linda family members, over and above the additional $108,901
7 in increases being requested in this adjustment.

8

9 **Q. What do you recommend?**

10 A. I recommend that the Rate Year increases granted to the Linda family members be
11 limited to 10%. This is more than the actual increases granted in any of the past five
12 years and is also well above the current rate of inflation. Since a 5% increase is
13 already included in Mr. Edge's Rate Year calculation, then I recommend that the
14 additional management salary increase be limited to 5%, as shown in Schedule ACC-
15 11. The net result will be a total salary and wage increase of 10% each for Susan
16 Linda, Raymond Linda, and Joshua Linda between the Interim Year and the Rate
17 Year.

18

19 **Q. Have you made corresponding adjustments to the Company's claims for**

1 **payroll-related taxes and pension expenses?**

2 A. Yes, I have. At Schedule ACC-12, I have made an adjustment to eliminate payroll-
3 related taxes consistent with my recommended salary and wage adjustments. To
4 quantify my adjustment, I used the payroll-tax related rates that are used in Schedule
5 WEE-8 of Mr. Edge's testimony. In that Schedule, Mr. Edge made adjustments to
6 FICA expense, unemployment compensation taxes, federal unemployment, and
7 Rhode Island unemployment expenses. I used the same tax rates inherent in his
8 schedule to quantify my adjustment.

9 In addition, I made a corresponding adjustment to pension expense.
10 Interstate has included a pension expense claim in its revenue requirement that is
11 based on an annual pension contribution of 3% of its salary and wage expense. I
12 have reduced this claim to eliminate the 3% payroll contribution on the management
13 salary increases that I recommend be excluded from rates. My adjustment is shown
14 in Schedule ACC-13.

15

16 **C. <u>Wharfage Fees</u>**

17 **Q. What is wharfage expense?**

18 A. Wharfage expense consists of amounts paid for dock space for the Company's
19 vessels. Several of the Company's wharfage agreements are with the State of Rhode
20 Island, and I am not recommending any adjustments to the Company's pro forma
21 claim for these leases with the State. However, two of the agreements are with
22 affiliated entities and I believe that these agreements require close scrutiny.

The first agreement at issue is between Interstate and Interstate Nav. Co. (not to be confused with Interstate Navigation Company), a Connecticut Corporation that owns the docketing facility at Block Island. This includes not only the dock itself but also certain buildings, and a loading and parking area. The Company has a lease for this site effective October 1, 1999 with a base rental of $120,000, to be increased annually based on the consumer price index ("CPI"). This lease was signed by John P. Wronowski (who I believe is Ms. Linda's brother) for Interstate Nav. and by Ms. Linda for Interstate. This lease expires on September 30, 2004. The Company also provided a second lease, with a term of June 1, 2004 through May 31, 2009, that increased the base rent to $237,500 and once again provided for annual increases based on the CPI. This lease has not yet been signed.

Similarly, Interstate provided a lease between Interstate and Waterfront Realty for lease of a docking space and other facilities necessary for the repair, maintenance, and storage of the Company's vessels. The term of this lease is from October 1, 1999 through September 30, 2019. This lease provides that,

> Waterfront Realty hereby leases to Interstate the docking space to be constructed at the Montville Yard and the use of the other Montville facilities for all of Interstate's present and future vessels at an annual cost commencing October 1 of each year, which said annual cost shall be equal to the sum of : (1) 80% of the principal, interest and other payments required for the repayment of the borrowing associated with the construction of the new docking facility; (2) 80% of any and all property and other taxes related to said facility; (3) 80% of all insurance costs related to said facility; and (4) 80% of all other costs related to the Montville Yard and its associated dock and other facilities, including, but not limited to, any repairs or improvements necessary for the term of this lease.

1 This lease was signed by Susan Linda on behalf of both Waterfront Realty and
2 Interstate.
3
4 **Q. What level of wharfage expense is Interstate requesting to include in rates in**
5 **this case?**
6 A. Following are the Test Year and Rate Year claims included by Interstate in its filing:
7

	Test Year	Rate Year	Increase
Point Judith	$39,356	$43,390	10.25%
Fort Adams	$8,500	$9,105	7.12%
Old Harbor	$120,000	$198,333	65.3%
Montville Dock	$43,284	$138,105	219.07%

8
9 The size of the increases for Old Harbor and Montville are significantly greater than
10 the increases included in the Company's filing for payments to the State of Rhode
11 Island.
12
13 **Q. Do any of these lease agreements constitute affiliated transactions?**
14 A. The Port Judith dock lease and the Fort Adams lease are both leases between
15 Interstate and the State of Rhode Island. Therefore, neither of these agreements is an
16 affiliated transaction. The Old Harbor dock lease is paid to Interstate Nav. Co.

1 Interstate contends that Interstate Nav. Co. is not an affiliate under Rhode Island law,
2 since no owner of Interstate Navigation Company owns or holds 10% or more of the
3 voting capital stock of Interstate Nav.
4 Wharfage fess for the Montville dock are paid to Waterfront Realty, which is
5 an affiliate as acknowledged by Interstate in the response to DIV 1-25. Interstate
6 states in this response that neither of the lease agreements with Interstate Nav. Co. or
7 with Waterfront Realty need to be filed with Commission since these are leases for
8 property, "not managerial, supervisory, construction, engineering, accounting,
9 purchasing, financial, or other services..."
10
11 **Q. What are your concerns regarding these affiliated transactions?**
12 A. Clearly, the leases with Interstate Nav. Co. and with Waterfront Realty were not the
13 result of arms-length negotiations and do not represent arms-length transactions. For
14 example, in the case of the Montville dock lease, Ms. Linda represented both parties.
15 A person is not able to negotiate with himself in an objective manner. The
16 Commission, then, must determine an appropriate cost to include in regulated rates
17 relating to these affiliated transactions.
18
19 **Q. Do you agree that Interstate Nav. Co. is not an affiliate of Interstate?**
20 A. I am not an attorney and therefore I cannot comment on whether Interstate Nav. Co.
21 meets the criteria for an affiliate under Rhode Island law. Nor will I comment on
22 whether the wharfage agreements are required to be filed with the Division.

1 However, even assuming that these agreements do not fall within the parameters of
2 affiliated agreements as defined by Rhode Island law, it is clear that these
3 agreements should be treated as affiliated transactions and regulated as such by the
4 Commission for ratemaking purposes.
5
6 **Q. Why do you believe that these leases should be regulated as affiliated interest**
7 **transactions?**
8 A. According to the response to DIV 3-5, Susan Linda, Ray Linda, and Josh Linda are
9 all owners of Interstate Nav. Co. Thus, all of the officers and directors of Interstate
10 are also owners of Interstate Nav. Co. With regard to the Montville lease, the board
11 members of Waterfront Realty are Susan Linda, Raymond Linda, and Joshua Linda.
12 Susan and Raymond Linda are also stockholders in Waterfront Realty.
13
14 **Q How has the Company attempted to justify the significant increases being**
15 **claimed in the wharfage fees paid to affiliates?**
16 A. The Company has attempted to justify the significant increases in wharfage fees paid
17 to Interstate Nav. Co. and to Waterfront Realty based on market value appraisals.[8]
18 However, as previously stated, the Commission should utilize a lower of cost or
19 market standard for these affiliated transactions. Moreover, the "cost" standard
20 should be based on what it would cost Interstate if it owned these properties directly.
21 Since these leases constitute affiliated transactions, the lease rates should be priced

1 at levels that reflect what it would cost Interstate to provide these services for itself,
2 i.e., the lease rates should be cost-based and return requirements should reflect the
3 net book value of the plant being leased and Interstate's cost of capital. The
4 Company should also be permitted to recover any operating expenses related to these
5 facilities that are necessary for the provision of safe and adequate service.
6
7 **Q. Did Interstate provide the Division with the net book value of the assets used in**
8 **Old Harbor and Montville?**
9 A. The Company provided the net book value of the Montville facility, but it did not
10 provide this information for Old Harbor. In response to DIV 3-7, Interstate stated
11 that the net book value of the Montville dock was $313,528 at December 31, 2003.
12 The Company also identified the annual depreciation expense. Therefore, I have
13 made an adjustment to include in rates a wharfage fee based on the average net book
14 value of the Montville facility during the Rate Year. My adjustment is shown in
15 Schedule ACC-14.
16 With regard to the Interstate Nav. Co. facility at Old Harbor, the Company
17 did not provide the net book value. Therefore, I recommend that the rental fee be
18 based on continuation of the current contract, which limits the annual increases to the
19 CPI. My adjustment is shown in Schedule ACC-15.
20
21

8 It is interesting to note that Interstate paid at least of a portion of the costs of these appraisals.

1 **D.** **Homeland Security**

2 **Q.** **Please describe the Company's claim for homeland security costs.**

3 A. In its revenue requirement claim, the Company included homeland security costs of
4 $547,460, as shown on Schedule WEE-7, page 2 to Mr. Edge's testimony. However,
5 as noted on that page, the Company is actually claiming total homeland security
6 costs of $702,105 in its filing, and it has indicated that it will update its schedules
7 accordingly.

8

9 **Q.** **How did the Company develop its claim?**

10 A. Interstate's claim is based on four components: vessel costs, facilities costs, company
11 costs, and stakeholder costs. The Company's projections are based on average first
12 year costs estimated in the Port Security Regulations issued by the Department of
13 Homeland Security, a copy of which was provided in response to COM-19.
14 Interstate is also proposing that costs for homeland security be restricted in a separate
15 account, so that ratepayers will receive the benefits of any over-collection.

16

17 **Q.** **Do you believe that the Company's claim is reasonable?**

18 A. No, I have several concerns with regard to the Company's claim. First, the first year
19 costs used by Interstate are higher than costs for subsequent years estimated in the
20 regulations. This is not surprising, since there are a number of start-up costs that will
21 be incurred in the first year but which will not be incurred in subsequent years.
22 Second, it is likely that Interstate's facilities will cost less than the average cost

1 contained in the regulations. Since these regulations deal with all size vessels and
2 facilities, it is likely that Interstate does not face as large a security risk as many
3 other facilities, such as major United States ports. Third, it appears that there are a
4 number of regulations from which ferry boat companies may be exempted, another
5 reason why the use of average costs may be excessive.
6
7 **Q. What do you recommend?**
8 A. Since the Company has agreed to a restricted account, I am not opposed to the use of
9 the average costs as stated in the regulations to determine the Company's homeland
10 security costs for purposes of this case. However, since the Company's first year
11 costs are greater than costs in future years, the Commission should use an average
12 annual cost over a multi-year period to determine the amount to include in the
13 Company's rates. I recommend that the Commission determine the average annual
14 cost over a five-year period, which is the period I am recommending for amortization
15 of rate case costs. My adjustment is shown in Schedule ACC-16.
16
17 **Q. Since the Company has agreed to a restricted account, why are you**
18 **recommending any adjustment to the amounts included in the Company's**
19 **claim?**
20 A. Even though a restricted account will be used, the Commission should still ensure
21 that the amount included in the Company's rates is not excessive. Interstate is
22 requesting a rate increase in this case of approximately 40%. Although I am

1 recommending several adjustments to the Company's claim, my recommendations
2 still result in a significant rate increase of over 12%. Therefore, the Commission
3 should ensure that the amounts included in the Company's claim are reasonable,
4 even if ratepayers will receive "credit" for any over-collections.
5
6 **Q. Do you have any other recommendations?**
7 A. Yes, I also recommend that the Company be required to retain the homeland security
8 funds in an interest bearing account, so that ratepayers receive the benefit of interest
9 in the event that the amounts collected from customers exceed the Company's actual
10 homeland security costs**.** I also recommend that Interstate be required to provide an
11 annual report detailing the amounts collected from ratepayers, the amounts spent for
12 homeland security, and the balance in the restricted account.
13
14 **E. Lobbying Expenses**
15 **Q. Are you recommending any adjustment to the Company's claim for lobbying**
16 **expenses?**
17 **A.** Yes, I am recommending that these expenses be disallowed.
18
19 **Q. Are lobbying costs an appropriate expense to include in a regulated utility's cost**
20 **of service?**
21 **A.** No, they are not. Lobbying expenses are not necessary for the provision of safe and
22 adequate utility service. Moreover, the lobbying activities of a regulated utility may

be focused on policies and positions that enhance shareholders but may not benefit, and may even harm, ratepayers. Regulatory agencies generally disallow costs involved with lobbying, since most of these efforts are directed toward promoting the interests of the regulated entity's shareholders rather than its ratepayers. Ratepayers have the ability to lobby on their own, on in conjunction with others, through the legislative process. They should not, then, be forced to reimburse regulated entities for lobbying costs through the ratemaking process. Moreover, lobbying activities have no functional relationship to the provision of safe and adequate service. If the Company were to immediately cease contributing to these types of efforts, service would in no way be disrupted. For all these reasons, I recommend that lobbying expenses be disallowed. My adjustment is shown in Schedule ACC-17. It should be noted that the adjustment shown in Schedule ACC-17 relates solely to Interstate's lobbying costs paid to Trion Communications. Lobbying costs paid to legal counsel are addressed below.

F. Legal Fees

Q. What is the Company's claim for legal fees in this case?

A. The Company is requesting recovery of legal expenses of $308,443. As shown below, Interstate has incurred significant legal fees over the past five years:

Fiscal Year	Legal Fees
Year Ending 5/31/99	$301,948
Year Ending 5/31/00	$242,047
Year Ending 5/31/01	$223,118
Year Ending 5/31/02	$277,213
Year Ending 5/31/03	$308,443

The level of legal expenses incurred over the past five years is significantly higher than the amounts traditionally spent by Interstate. In the Company's last base rate case, which was based on a Rate Year ending May 31, 1998, Interstate claimed legal expenses of $37,000. Its claim in this case represents an increase of over 700% from the legal expenses approved in the last case.

Q. What is the reason for the significant increase in legal expenses?

A. Interstate has been heavily involved in several proceedings over the past five years that are now resolved, the most notable of which were the proceedings involving IHSF. The Company participated in proceedings involving IHSF's application for a Certificate of Public Convenience and Necessity ("CPCN"), a Superior Court appeal of the Division's decision to grant a CPCN to IHSF, the first rate case of IHSF before the Commission, various Supreme Court appeals, and other issues involving Interstate's competitor. This litigation is essentially complete.

1 Interstate was also involved in several disputes with the Town of
2 Narragansett relating to tax and landing fee issues. I understand that these issues
3 have now been resolved. Extensive legal work on the Point Judith project was also
4 provided to Interstate. As noted previously, the Company intends to complete that
5 project in the Rate Year and therefore the associated legal costs should not reoccur.
6 While the Company will continue to incur costs associated with homeland security,
7 my revenue requirement recommendation includes significant cost recovery for
8 activities involving homeland security issues. Legal expenses relating to rate case
9 activities are also provided for separately. Legal advice was also provided during
10 the past few years on issues regarding the death of certain shareholders and on issues
11 involving the captain of the MV Nelseco, which hopefully will not reoccur in the
12 immediate future. I understand that many of the PUC/DPUC legal matters shown in
13 Schedule 13 of Mr. Edge's testimony have now been resolved. The Company has
14 also now resolved significant litigation that was filed in United States District Court
15 regarding its overtime practices. In summary, while the Company's legal expenses
16 were unusually high during the past five years, there is no indication that this level of
17 legal expense will continue in the Rate Year.
18 The Company has not provided any affirmative evidence to support its claim
19 that the Test Year level of legal activity is expected to continue in the Rate Year.
20 Moreover, based upon the level of legal expenses included in the Company's last
21 base rate case and the fact that many of the activities undertaken in the past five
22 years are now complete, I believe that the Company's legal expense claim is

1 significantly overstated.

2

3 **Q. What do you recommend?**

4 A. I recommend that the Commission include annual legal expenses of $44,350 in

5 Interstate's revenue requirement. This recommendation is based on the amount of

6 legal expenses included in the Company's last base rate case, adjusted for inflation

7 through the Rate Year. My adjustment is shown in Schedule ACC-18.

8 I have asked Interstate some additional discovery regarding its historic legal

9 expenses. If appropriate, my recommendation could be modified based on additional

10 evidence that would support a higher level of Rate Year expense. However, at this

11 time, the Company has not adequately supported its Rate Year claim for legal costs,

12 especially in light of the significant proceedings in which the Company has been

13 involved in the past few years and the fact that this level of activity is unlikely to

14 reoccur.

15

16

17 **G. <u>Advertising Costs</u>**

18 **Q. What has the Company included in its claim with regard to advertising costs?**

19 A. The Company has included adverting costs of $350,000 in its claim. This represents

20 an increase of approximately 78% from its actual Test Year costs of $196,917. The

21 Company claims that it needs this increase because "Interstate is currently faced with

22 a one boat, summer only hi-speed competitor that has an advertising budget of

1 $100,000 (approved by this Commission). If Interstate is to survive and protect its
2 lifeline service, it must advertise."
3
4 **Q. Did the Company provide details of the proposed advertising program?**
5 A. No, it did not. Interstate claimed in the response to DIV 1-34, that it "consulted with
6 its marketing and advertising agency, who came up with the $350,000 budget…"
7 The budget prepared by the advertising agency does not include specific information
8 regards ad or other details, but simply allocates that $350,000 among various cost
9 categories such as "Newsprint Media and Placement", "Radio Media and
10 Placement", "Television Media and Placement", and a few other categories, as
11 shown in the response to DIV 1-34. Interestingly, the $350,000 budget even
12 includes $3,000 for "Marketing Budget Development". It appears that the $350,000
13 may be nothing more than a wish list created by the very entity that stands to gain the
14 most from an inflated advertising budget. There is no comprehensive program
15 associated with this "budget". Nor is there any indication that alternatives were
16 critically evaluated by Interstate. Budgeted numbers are rarely acceptable for
17 ratemaking purposes, since they often represent a hopeful expectation rather than a
18 meaningful attempt to develop the best possible program for a regulated entity. For
19 these reasons, I recommend that the Company's request to increase its advertising
20 expense by 78% be denied.
21
22 **Q. What do you recommend?**

A. I recommend that the Commission reflect 10% annual increases in advertising costs from the Test Year through the Rate Year. As shown in Schedule ACC-19, this would result in a total increase of $41,353 over the actual Test Year expenditure. This moderate increase will result in an advertising budget that is still more than twice the budget approved by the Commission in the IHSF case, as reported by Interstate, but will hopefully result in a more focused and efficient program than the use of an advertising agency budget.

H. Regulatory Commission Expense

Q. What has the Company included in its filing for rate case expense?

A. As shown on page 22 of Mr. Edge's testimony, the Company's claim includes the following costs:

Cost of Service (Accounting)	$ 50,000
Legal	50,000
Division	30,000
Commission	20,000
Total	$150,000
Amortization Period	3 Years
Annual Amortization	$ 50,000

Q. Are you recommending any adjustment to the Company's claim?

A. I am not recommending any adjustment to the amount of rate case costs being claimed by Interstate, but I am recommending a longer amortization period. Docket No. 1935 was resolved in December 1989 and Docket No. 2484 was resolved in May

1997. Therefore, rates in each of the past two cases were effective for over seven years. Given that that the last two cases resulted in rates that were effective for periods exceeding seven years, I believe that an amortization period of 3 years, as recommended by Interstate, is too short. I therefore recommend that an amortization period of five years be used to amortize the Company's rate case cost claim in this case. A five-year period is reasonable in light of the Company's rate case history since Docket No. 1935. My adjustment is shown in Schedule ACC-20.

I. Telephone Expense

Q. What has been the history of the Company with regard to telephone expense?

A. According to Schedule WEE-4, over the past five years, the Company's telephone expenses have been as follows:

Fiscal Year	Telephone Expenses
Year Ending 5/31/99	$76,043
Year Ending 5/31/00	$75,405
Year Ending 5/31/01	$90,890
Year Ending 5/31/02	$105,035
Year Ending 5/31/03	$116,408

The Company used the average annual increase over the last five years to develop its recommended increase of 10% for the Interim Year and the Rate Year.

1

2 **Q. Do you believe that the Company's claim is reasonable?**

3 A. No, I do not. Interstate indicated that the significant increase that has occurred in
4 telephone expenses over the past few years is due to the increase in "charges for the
5 computer lease lines and the increased use of cellular phones."[9] However, I would
6 not expect these increases to continue into the future, particularly costs associated
7 with cellular phone usage, for two reasons. First, given the increases over the past
8 three years, it is likely that personnel to whom cellular phones are likely to be issued
9 have received them by now. Cellular phone usage has increased in all businesses
10 over the past few years, but these increases will not continue indefinitely unless the
11 overall business is expanding. Second, cellular phone companies are becoming
12 increasingly competitive and rates for certain plans have actually declined, rather
13 than increased, over the past few years. Therefore, while these increases may have
14 been reasonable in the past given wider cellular phone distribution, it is unlikely that
15 this level of growth will continue and costs may in fact decline.

16

17 **Q. What do you recommend?**

18 A. I recommend that the actual Test Year costs be used in the Company's revenue
19 requirement. Interstate has not demonstrated that these costs will necessarily
20 increase at all, and certainly not by the 10% annual increase included in its claim.
21 My adjustment is shown in Schedule ACC-21. It should be noted that the Company

has increased its computer costs by 5% annually, and I am not recommending any adjustment to that claim. Given the increase that I have included in the Company's computer expense, the fact that cellular phone penetration among employees should be stabilized, and the declining prices in cellular phone usage costs, I believe that that use of the actual Test Year expense is reasonable.

J. Miscellaneous Expenses

Q. How did the Company determine its claim for miscellaneous expenses?

A. As shown on Schedule WEE-7, page 1, Mr. Edge used the actual test year expense.

Q. Do you believe that the Company's claim is reasonable?

A. No, I do not. Almost by definition, miscellaneous charges fluctuate from year-to-year. The Company recognized this in its filing in Docket No. 2484,and used a five - year average for these costs. Over the past five years, the Company has incurred the following level of miscellaneous costs:

9 Response to DIV 1-36.

Fiscal Year	Miscellaneous Expenses
Year Ending 5/31/99	$8,107
Year Ending 5/31/00	$ 0
Year Ending 5/31/01	$ 229
Year Ending 5/31/02	$1,179
Year Ending 5/31/03	$9,009
Five Year Average	$3,705
Three Year Average	$3,472

A review of miscellaneous costs over the past five years indicates that the three-year and five-year averages are relatively similar, providing further support for the inclusion of an average cost in the Company's revenue requirement rather than the actual Test Year expense. In this case, I am recommending that a five-year average be used for miscellaneous expenses. My adjustment is shown in Schedule ACC-22.

K. <u>Depreciation Expense</u>

Q. Please describe your adjustment to the Company's depreciation expense claim.

A. Since I am recommending several adjustments to the Company's plant in service claims, it is necessary to make a corresponding adjustment to the Company's depreciation expense claims. Specifically, I am recommending adjustments to the

Company's rate base claim relating to the Montville dredging project and to purchase of the MV Anna C. Therefore, it is necessary to make a corresponding adjustment to eliminate the associated depreciation expense.

Q. How did you quantify your depreciation expense adjustments?

A. The Company did not provide the depreciable lives used for post-Test Year plant additions in its filing, but Mr. Edge did provide this information to me verbally. According to Mr. Edge, he used a 10-year depreciable life for both the Montville dredging project and for the depreciation of the MV Anna C. Therefore, at Schedule ACC-23 and Schedule ACC-24, I have applied a depreciable life of 10 years to my recommended plant in service adjustments to determine the associated annual depreciation expense adjustments.

L. Income Taxes at Current Rates

Q. Please discuss your adjustment to remove income taxes at current rates.

A. Schedule WEE-7 of Mr. Edge's testimony presents "Adjusted Rate Year" revenues, expenses, and gain(loss) at current rates. The adjusted rate year financials are then further adjusted to reflect the impact of the rate increase being requested by the Company.

In adjusted rate year expenses at current rates, the Company has included $105,701 in income tax expense. However, the Company will not pay any income taxes at current rates. Since the Company is projecting a taxable loss for the rate

1 year under current rates, no federal income taxes would be due. Thus, Interstate has
2 incorrectly included these federal income taxes as being due under its Adjusted Rate
3 Year scenario, when they are more appropriately included under a pro forma analysis
4 at proposed rates. At Schedule ACC-25, I have made an adjustment to eliminate
5 Interstate's claim for these taxes under its estimate of pro forma expense at present
6 rates. It should be noted that in making this adjustment, I am not disallowing the
7 Company's claim for recovery of income taxes, I am simply moving these taxes
8 from the present rate scenario to the proposed rate scenario.
9 Furthermore, in order to determine my recommended pro forma income at
10 present rates, it was necessary to develop a pro forma level of revenues and expenses
11 that incorporate the Division's recommended adjustments. This income statement is
12 shown in Schedule ACC-4. Income tax liability is simply a function of the revenues
13 realized and operating expenses incurred. Therefore, in Schedule ACC-4, I have
14 reflected the Division's pro forma revenue and expense recommendations, exclusive
15 of taxes, and then calculated the pro forma income taxes at current rates based on the
16 net result of all of these recommendations. Given this methodology, it is necessary
17 to eliminate pro forma income taxes from the Company's expense level, in order to
18 ensure that the Division's pro forma income taxes appropriately reflect the level of
19 revenues and expenses being recommended in this testimony.
20
21 **Q. What federal income tax rate did you use?**
22 A. As shown on Schedule ACC-26, I have utilized a composite federal income tax rate

1 of 34%. This is the statutory rate, given the level of operating income that is being
2 proposed for Interstate. It should be noted that this tax rate differs from the tax rates
3 shown in Schedule WEE-17 to Mr. Edge's testimony. I have spoken to Mr. Edge
4 about this issue and I understand that Mr. Edge agrees with the use of a 34% income
5 tax rate.
6
7 **M. Gross Receipt Taxes**

8 **Q. Please explain your adjustment relating to the Company's gross receipt taxes.**

9 A. This adjustment is somewhat similar to the income tax adjustment discussed above.
10 I eliminated gross receipts taxes from the Company's operating expenses, so that its
11 expenses would not vary with variations in the level of revenue under present or
12 proposed rates. Instead of including gross receipts taxes as an operating expense, I
13 included gross receipts taxes in my Income Statement as a separate line item of
14 variable expense that fluctuates with changes in pro forma revenue. Elimination of
15 gross receipts taxes from the Company's expense claim is shown in Schedule ACC-
16 27.

17 Gross receipts taxes based on the Division's pro forma revenue
18 recommendation, at both present and proposed rates, are shown on the Income
19 Statement in Schedule ACC-4. I have calculated gross receipts taxes at a rate of
20 1.25%. The Company used a rate of 1.5% in its filing, but I understand that the
21 statutory rate is only 1.25%.
22

1 **N. Interest Synchronization**

2 **Q. Have you adjusted the pro forma interest expense for income tax purposes?**

3 **A.** Yes, in calculating the Company's pro forma income tax expense, I have reflected an
4 interest deduction based on the interest synchronization methodology. I have made
5 this adjustment at Schedule ACC-28. My pro forma interest expense is therefore
6 consistent (synchronized) with my recommended rate base, capital structure and cost
7 of capital recommendations.

8

9 **O. Revenue Multiplier**

10 **Q. What is the revenue multiplier?**

11 A. The revenue multiplier is the factor that represents the amount of revenue a company
12 must receive in order to earn an additional unit of income. On Schedule ACC-29, I
13 have calculated a revenue multiplier of 1.534331 for Interstate. This revenue factor
14 includes gross receipts taxes at 1.25% and federal income taxes at the statutory rate
15 of 34%.

16

17 **P. Operating Income Summary**

18 **Q. What is the impact of your recommended adjustments on the Company's**
19 **operating expense and income at present rates?**

20 A. As summarized on Schedule ACC-5, my recommended adjustments will decrease
21 the Company's operating expenses by $1,397,757, from $8,698,901 to $7,301,144.

22

VII. REVENUE REQUIREMENT SUMMARY

Q. What is the result of the recommendations contained in your testimony?

A. The Division is recommending a rate increase of $902,951 for Interstate. As shown in the Income Statement provided in Schedule ACC-4, the Division's analysis indicates that the Company has pro forma revenue at present rates of $7,348,276, pro forma operating expenses of $7,301,144, and pro forma gross receipts taxes of $91,853. At present rates, the Company is projected to have operating income of $98,350 in the Rate Year.

A revenue increase of $902,951 will result in pretax income of $846,943 for Interstate. After an interest deduction of $376,078 and payment of federal income taxes of $160,094, the Company will have net income at proposed rates of $310,771.

Total operating income will be $686,849, which includes net income of $310,771 (return on equity) and interest expense (return on debt) of $376,078. This total pro forma operating income of $686,849 will be sufficient to provide an overall rate of return of 7.33%, allowing the Company to earn 10.00% on equity.

The Division's recommendations result in an overall increase of 12.29% on total revenue, as shown on Schedule ACC-1. Dr. Stutz addresses the Division's recommendations with regard to rate design and makes specific recommendations regarding how this revenue increase should be recovered from Interstate's various customer classes.

1 **Q. Does this complete your testimony?**

2 A. Yes, it does.