Direct Testimony
of
James A. Rothschild

March 2004
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I. STATEMENT OF QUALIFICATIONS OF JAMES A. ROTHSCHILD

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.
A. My name is James A. Rothschild and my address is 115 Scarlet Oak Drive, Wilton, Connecticut 06897.

Q. WHAT IS YOUR OCCUPATION?
A. I am a financial consultant specializing in utility regulation. I have experience in the regulation of electric, gas, telephone, sewer, and water utilities throughout the United States.

Q. PLEASE SUMMARIZE YOUR UTILITY REGULATORY EXPERIENCE.
A. I am President of Rothschild Financial Consulting and have been a consultant since 1972. From 1979 through January 1985, I was President of Georgetown Consulting Group, Inc. From 1976 to 1979, I was the President of J. Rothschild Associates. Both of these firms specialized in utility regulation. From 1972 through 1976, Touche Ross & Co., a major international accounting firm, employed me as a management consultant. Touche Ross & Co. later merged to form Deloitte Touche. Much of my consulting at Touche Ross was in the area of utility regulation. While associated with the above firms, I have worked for various state utility commissions, attorneys general, and public advocates on regulatory matters relating to regulatory and financial issues. These have included rate of return, financial issues, and accounting issues. (Appendix A.)

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?
A. I received an MBA in Banking and Finance from Case Western University (1971) and a BS in Chemical Engineering from the University of Pittsburgh (1967).
II. BACKGROUND AND PURPOSE

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The Town of New Shoreham requested that I examine the proposal made by Interstate Navigation to increase its rates for Ferry service from Pont Judith, RI to Block Island, RI by $2,750,712 or 39.82% and to advise the Town of any comments on the filing I feel are appropriate.

Both the Town and I appreciate the importance of the Interstate Navigation ferry service to Block Island. We want rates to be high enough to permit the company the opportunity to provide safe and adequate service, but not so high as to burden the residents and visitors to Block Island with prices that are higher than necessary.
III. SUMMARY OF FINDINGS AND RECOMMENDATIONS

Q. PLEASE SUMMARIZE YOUR FINDINGS AND RECOMMENDATIONS IN THIS CASE.

A. Interstate Navigation has requested a rate increase way in excess of the amount needed. This testimony will show why a rate increase of $244,160, or 3.11% will provide the Company with a reasonable opportunity to cover its reasonable operating expenses and provide a fair return on used and useful rate base. This is far less than the $2,750,712 increase requested by the Company.

Rates are supposed to be set based upon normal conditions. This concept is especially important when setting rates for a company such as Interstate Navigation that has a history of many years between rate cases. Interstate Navigation is currently in a period of maximum uncertainty, making this a time to be extremely careful about how permanent rates are set. Overestimation of Interstate Navigation’s cost of doing business could put the Company in a position to overcharge passengers for years.

Interstate Navigation’s business has recently been impacted by:

1. A new high-speed ferry service that provides some competition for Interstate Navigation began in mid-2001. The total impact of the new service is difficult to isolate. Passenger volume in 2003 was

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1 Interstate Navigation last increased its rates in 1997. Before that, its last rate increase was 1989.
down because of unusually poor weather. See Schedule JAR 8. Therefore it is impossible to say if the passenger drop was all due to weather conditions or if the high-speed ferry service penetrated further into the business of Interstate Navigation. Isolating the effect is complicated by that lack of actual passenger or revenue data from the company providing the high-speed service.

2. The elimination of competition from ferrying automobiles from New London, CT to Block Island, RI will improve demand for Interstate’s ferryboat service going forward. People who were using the New London service will now have to use the service from Point Judith to get a car onto Block Island.

3. The elimination of competition of normal speed passenger ferry service from New London, CT to Block Island, RI will further impact the future business of Interstate Navigation. Passengers not bringing cars who used to use the New London service who still choose to come to Block Island will now have to either use the new premium priced high-speed ferryboat service from New London or go to Point Judith and take either the high-speed ferry or an Interstate Navigation ferry.

4. Once the Carol Jean is renovated and back in service and the Anna C is in full-time service to Block Island, the improved capacity for both automobiles and people and improved speed of Interstate Navigation’s service from Point Judith, RI, to Block Island, RI will
greatly increase future revenues before considering the impact of any rate increase. People wanting to bring cars onto Block Island have been severely limited by available capacity. The new automobile capacity will quickly be utilized by pent-up demand.

5. The impact of normal business fluctuations from one season to another due to factors such as weather and economic conditions makes it challenging to isolate cause and effect.

6. The need to provide an as yet uncertain amount of additional effort for security.

7. New marketing plan proposals being made by Interstate Navigation, including expanded advertising, group discounts, and the flexibility for mid-week discounts, if implemented could impact future revenues in unpredictable ways. There are not even any marking plans to support any of the proposed discount proposals.

The above issues make the determination of likely future revenues at current rates and the level of future expenses more uncertain than usual. It would be unfair to the Company to set permanent rates based upon an unrealistically low future expected revenue level. Likewise, it would be unfair to the people who rely upon the ferry service of Interstate Navigation to pay for ferry service based upon an overly pessimistic future revenue and expense level.
My analysis of both the weather conditions and the strong pent-up demand for automobile service makes me confident that my revenue forecast is realistic. I also recognize that absent hard data of what the operations of Interstate Navigation’s ferryboat business looks like in a normal weather year, after the vehicle capacity is increased, and after the non-automobile service is added from New London, not all will agree on what future revenue forecast is appropriate. Therefore, to reduce the sensitivity of the revenue forecast, I recommend a safety net. To ensure that the interests of investors and ratepayers is balanced, I propose that the overall rate level Interstate Navigation be allowed to charge be dependent upon actual future revenue levels achieved in the first two years after Interstate Navigation has full use of its new and newly renovated fleet. The plan that I propose will enable permanent rates to be based upon additional key data showing how the addition of new capacity and both the addition and subtraction of competition actually impacts the business of Interstate Navigation while saving the expenses associated with a full rate case. Specifically, I propose the following:

a) Interstate Navigation be allowed to currently increase its current rates by $244,160, or 3.11% for service beginning June 1, 2004.

b) FIRST ADJUSTMENT PERIOD. If total actual revenues earned by Interstate Navigation from April 1, 2005 through
March 31, 2006 plus a pro-forma adjustment to annualize the impact of any new rate increases implemented between April 1, 2005 and March 31, 2006 are less than $8,478,000\(\text{2}^{\text{2}}\) then Interstate Navigation should be allowed to further increase its rates starting on June 1, 2006 by the lesser of the percentage that actual annualized revenues fall below $8,478,000, or 10%. This increase is conditioned on the expectation that all three of the planned vehicle carrying vessels will be utilized to provide full service between Point Judith and Block Island during the summer season of 2005 and that there are no serious quality of service issues found by the Commission to have improperly suppressed revenues.

c) SECOND ADJUSTMENT PERIOD. If total actual revenues earned by Interstate Navigation from April 1, 2006 through March 31, 2007 plus a pro-forma adjustment to annualize the impact of the new rate increase (if any) implemented on June 1, 2006 are less than $8,092,191, then Interstate Navigation should be allowed to further increase its rates starting on June 1, 2006 by the percentage that actual annualized revenues fall below $8,092,191 with the maximum rate increase capped at no more than an additional 5%. Conversely, if revenues for this

\(\text{2}^{\text{2}}\) $8,092,191 I forecast plus my recommended rate increase of $244,160.
second rate adjustment period are higher than $8,092,191 then

Interstate Navigation shall implement a rate decrease equal to
the lesser of the actual percentage revenues exceed $8,092,191
or 10% whichever is less. Any rate increase is conditioned on
the expectation that all three of the planned vehicle carrying
vessels will be utilized to provide full service between Point
Judith and Block Island during the entire prime season of 2006
and that there are no serious quality of service issues found by
the Commission to have improperly suppressed revenues.

The above revenue adjustment proposal assumes that the Company’s
request for partial price deregulation and flexible pricing will be rejected.
Otherwise, the Company could use such flexibility to artificially constrain
revenues until the pricing flexibility time has passed. The above plan is not
perfect because future rates could be unduly influenced in the future by
abnormal weather as was the case in 2003. However, absent a reliable
mechanism to “normalize” revenues for weather, what I have proposed is far
superior to the unrealistically pessimistic revenue forecast made by the
Company. Ferryboat passengers are more at risk than the Company from the
above plan because the above plan does not prohibit the Company from filing
another rate case whereas it is highly unlikely that the Company would be

3 The potential rate decrease is higher than the potential rate increase because there is no provision for
a potential rate decrease in the first adjustment period.
forced to lower its rates should the Company find itself in a position where it
is over-earning.

The rate increase that I propose be currently allowed to Interstate
Navigation is based upon an estimate of $7,848,031 of revenues that the
Company will be able to earn at current rates. This is approximately
$500,000 more than the actual revenues earned by Interstate Navigation for
the Test Year, and is $941,000 more than the $6,907,031 proposed by
Interstate Navigation for the Rate Year. The reasons why my Rate Year
revenue forecast is more appropriate than the one proposed by the Company,
as explained later in this testimony, is to avoid placing illogical blame on the
high-speed ferry for the weather-related decline in revenues and to recognize
that the increased capacity to carry more vehicles will be highly utilized in
season.

Because the company has failed to provide any detailed plan and
associated quantification of its claimed expenses for Homeland Security, I
have excluded any increase in these costs from rate year expenses. This
exclusion is intended to protect the Homeland Security expense from
becoming a method to cause profits to become excessive. However, to the
extent it is necessary for Interstate Navigation to increase Homeland Security
related expenses beyond those included in the Rate Year, it is not intended for
the Company to suffer a loss as a result of providing what could be a
necessary and important service. Therefore, it is proposed that the Company
be granted permission to accrue incremental Homeland Security Expenses for
the next three years or until the time of the next rate case, whichever comes first. The Company should be allowed to earn interest on any accrued balance at the same interest rate it is paying on the debt for the Anna C. At the end of the accrual period, the Commission should review the accrued expenses. To the extent these accrued expenses are found appropriate and reflective of necessary expenses that are incremental to what is allowed for in the Rate Year, the Company should be permitted to recover both the prior expenses and a reality-based estimate of future expenses in future charges to ferryboat passengers.

My recommended rate increase is based upon:

a) a cost of equity of 9.50% rather than the 11.50% requested by the Company. This conclusion is based upon detailed cost of capital testimony I have filed in recent rate cases.

b) a rate base of $7,774,650 which is $3,690,870 lower than the $11,465,420 used by the Company. The primary differences in rate base result from the exclusion of the majority of the cost of the Anna C based upon advice from Ms. Crane that ratepayers have already been paying for the cost of this vessel based upon rate base rate of return principles. I have also adopted Ms. Crane’s recommended reduction in the capital cost of the Montville Dredging project. Working capital and Capital Additions in Process have been reduced for the reasons explained later in this testimony. Additionally, I have made a subtraction
from rate base using an estimated amount for deferred income
taxes. Deferred income taxes are routinely subtracted from rate
base because such funds are a cost-free source of funds to the
company.

c) operating expenses at current rates are based upon $7,354,927 of
expenses in the Rate Year. This is $1,238,274 lower than the
$8,593,201 requested by the Company but does still provide the
Company with $485,515, or 6.6% more in expenses than the
$6,869,412 quantified by the Company for the adjusted Test Year.

The basis for the difference between the cost of equity, rate base, and
operating expenses is explained in the appropriate sections later in this
testimony.

Q. ARE THERE ANY OTHER OVERVIEW CONCLUSIONS YOU WISH TO
MENTION?

A. Yes. This rate increase includes recognition of the costs associated with a
major renovation of one of the Company’s ferryboats, the acquisition of
another ferryboat, and the cost of major planned renovations to pier facilities
at Point Judith. Upon the completion of these projects, the company’s rates
will include an annual allowance for depreciation expense of approximately
$943,083 if my depreciation expense allowance is adopted and would be $1.2
million if the Company’s requested depreciation expense were allowed by the
Commission. This means the Company will recover from passengers between $0.9 and $1.2 million of its capital in each year. As a percentage of rate base, this is a very high amount --- much higher than is generally encountered in utility rate cases. As depreciation accumulates, rate base declines. The revenue requirements associated with $943,083 annual decrement to rate base will be available to the company to offset future increases in operating expenses and/or increase the future earned return on rate base.
IV. Revenues

Q. PLEASE EXPLAIN WHAT YOU HAVE CONSIDERED TO DETERMINE THE LEVEL OF REVENUES AT CURRENT RATES THAT SHOULD BE USED IN THIS CASE.

A. There are important positive factors that should result in a material improvement in the revenues earned by Interstate Navigation even without any rate increase. These factors include:

1. Anna C replacing Nelseco. The Company is planning to replace its small, non-vehicle carrying ferryboat, the Nelseco with the Anna C. The Nelseco has a capacity of 850 people and 0 cars, while the Anna C has a capacity of 1,300 people plus 35 cars. The car capacity of the Anna C is equal to the car capacity of the other two ferryboats that will be in regular peak-season service from Point Judith to Block Island. Therefore, the peak-season capacity to carry vehicles will increase by 50% as a result of adding the Anna C. The capacity to carry people will increase by about 50% on those runs that the Anna C replaces the Nelseco. However, the Nelseco is currently only used for two round-trips per day in the peak season on Monday-Thursday, one trip on Friday, and between 3-4 trips on the weekends. If the Anna C is used as frequently as the other two vehicle-carrying ferries, then Interstate Navigation could increase the number of trips with ferries carrying vehicles from 6 each way to nine
each way on Monday-Thursday, from 6 1/2 to 9 each way on Friday, from 6 to 9 each way on Saturday, and from 6 1/2 to 9 each way on Sunday.

Adding the Anna C to full-time service between Point Judith and Block Island will not only increase revenues because of the added automobile capacity and added people capacity, but will also improve the desirability of Interstate Navigation’s service compared to the High Speed Ferry service because:

a) As Interstate Navigation has acknowledged in the past, passengers prefer the more sea-kindly ride of the Anna C as compared to the Nelseco. While not specifically stated by Interstate Navigation, this has to mean that more passengers will chose the Anna C instead of the High Speed ferry simply because the Anna C is a more comfortable choice than the Nelseco.

b) The easier availability of automobile space will allow more passengers to choose to take their car over to Block Island. Those extra passengers that do take their cars will take the Interstate Navigation service instead of the Intestate High Speed Ferry Service because they will choose to ride with their car. The Company acknowledged that the great majority of its current trips, including all of its Friday, Saturday, and Sunday
trips have been operating at 100% of its capacity for cars. See the response to Town of New Shoreham interrogatory # 7.

2. **Increasing the Engine Size in the Carol Jean.** The company has requested in this rate case $3 million to upgrade the Carol Jean. This upgrade includes replacing its current 450 horsepower per engine to 1,200 horsepower per engine. The higher horsepower will increase the speed of the Carol Jean, thereby increasing its desirability. According to the response to information request #3 from the Town of New Shoreham, the new engines in the Carol Jean will reduce its trip time from 65 minutes to 55 minutes. This 10 minute reduction lowers the time differential between the Carol Jean and the competing high-speed ferry from 30 minutes longer to only 20 minutes longer. This time reduction combined with location benefits for where the Carol Jean docks on Block Island will provide at least some improvement in the passenger market share taken by the Carol Jean. The planned renovation of the Carol Jean should be completed before the prime season of 2005.

3. **Elimination of Competition from New London.** Removing the Anna C from New London service will provide current passengers desiring to take cars to Block Island with no other alternative than to use the Interstate Navigation service from Point Judith. While some of the former New London passengers will no doubt use the new high speed ferry service planned to be added to New London, many will use the
Interstate Navigation ferry service either because of price, ability to carry automobiles, or as in the past a more flexible schedule.

4. Weekend Weather. In the summer of 2003, an unusual number of weekends had cold, rainy weather. See Schedule JAR 8. This no doubt caused a material drop in people coming to Block Island either for the weekend or for weekend day trips. A return to normal weather will improve revenues for Interstate Navigation.

Interstate Navigation’s witness, Mr. Edge, only added $174,000 incremental revenues due to the increased vehicle capacity made possible by the Anna C. He did not provide any analysis of the degree that the existing ferry service was operating at full capacity for vehicles. I have substantial personal experience with Block Island, visiting there many times. I also know people who own homes on the Island. They advise me that getting a car onto and off Block Island in season is challenging. Several years ago, it used to be possible to get a car on the Island without a reservation merely by showing up at 6:00 AM and getting on a stand-by line. In recent years, this stand-by approach has become quite problematic. Furthermore, on very busy weekends such as a July 4th weekend with good weather, even the parking lots serving the ferry boats at Point Judith fill up. For that weekend in 2003, people were turned back by State Troupers because there was no space for their cars. Additional car capacity made possible because of the Anna C would not only result in greater car revenues for Interstate Navigation, but by keeping the parking lots in Point Judith less full, the extra car capacity would increase passenger utilization as well.
Due to the difficulties of getting a car on and off Island in the peak season, many residents leave one car at Point Judith or borrow a friend’s car that has been left at Point Judith. Additional automobile capacity, if available, would enable more Islanders to use their own car rather than having to burden friends.

In addition to being faster, the high speed ferry service from Point Judith to Block Island is a more luxurious service than that provided by Interstate Navigation. However, it is also more expensive, and goes into the Great Salt Pond on Block Island rather than into the downtown area as does the Interstate Navigation ferry service. For those whose destination is to town, hotels that surround the town, or the major beaches near downtown, the Interstate Navigation service will get people to their ultimate destination more quickly than those who take the high speed service. Furthermore, while the price difference might be relatively modest for some people who are traveling either by themselves or with a spouse, the price difference becomes much more substantial for a family with multiple children. These factors combine to mean that the high-speed ferry service is not and will not be for everybody. It has likely taken most, if not all, of the business it is going to capture from Interstate Navigation as there are just so many of the passengers that fit the profile of those that will chose the high speed ferry service.

I also observed that revenues earned by Interstate Navigation in the year ending 5/31/03 totaled $7,294,090, a number that was somewhat lower than the $7,599,632 earned in the prior year. However, if the revenues from the sale of the NV Manisee are excluded, then revenues in the year ending 5/31/03 were only very slightly below the $7,342,784 earned in the year ending 5/31/01, and were somewhat higher than the $7,182,732 earned in the year ending 5/31/00 and the $7,183,955 earned in the year ended 5/31/99.
The drop-off in revenues for 2003 was also experienced by the ferry service from New London to Block Island. See Schedule JAR 7. Since there was no competing high speed service from New London, the drop-off in New London service confirms that at least part of the business drop-off experienced by Interstate Navigation was related to normal seasonal variation factors such as weather and the economy.

Schedule JAR 8 shows that weather conditions in the summer of 2003 were far inferior to those of 2002. In July and August, there were 6.12 inches of rain on Block Island as compared to 1.36 inches of rain in the prior year. Of the 9 weekends in July and August had at least some rain in 2003 as compared to no rainy weekends in 2002. There were 14 days with rain in July and August of 2003, compared to 7 rainy days in 2002.

Q. IN CONSIDERATION OF THE ABOVE FACTORS, HOW HAVE YOU DETERMINED REVENUES AT CURRENT RATES?

A. While the preponderance of evidence supports the likelihood that even without a rate increase, the revenues of Interstate Navigation will be substantially higher in the future than it was in recent years, the Company's business is undergoing so much change that it is impossible to provide a precise quantification of what future normal revenues will be. Given that the capacity of the high-speed ferry is 250 people with six round-trips per day, the total capacity of the high-speed ferry is 1,500 passenger round-trips per day. The capacity of the Anna C is 1,300 passengers per trip and could make as many as three trips per day, for a total of 4,600 round-trip passengers per day. This compares to no more than 2,550 passenger round-trips per day on the Nelesco that the Anna C is replacing. The net increase in capacity from switching to the Anna C is greater than the total capacity of the high-speed
ferry. The elimination of automobile service from New London and the
addition of a high-speed ferry service from New London will have conflicting
impacts on Interstate Navigation’s business. The presumably higher prices
the high-speed ferry from New London will charge, the inability of the New
London high speed ferry to carry cars will serve to increase demand for
Interstate Navigation. The limited schedule that will also likely be available
from New London will cause many who come to Block Island from points
west of New London will to continue to drive to Point Judith. However,
those who do not plan to bring a car onto Block Island, are not concerned
about the fee for the high speed ferry, and can work around will likely be a
more limited schedule from New London, the New London high speed ferry
could become an attractive alternative. It follows that this New London high
speed service will provide more competition to the Point Judith high speed
ferry service than to the Interstate Navigation traditional ferry service unless
Interstate Navigation raises its rates to the point where it looses some of its
price advantage because people who are willing to pay for the higher price of
the high speed ferry are more likely to be among those willing to pay a
premium for high speed service from New London.

In consideration of the above, a conservatively low estimate of
passenger revenues is achieved by estimating that revenues at present rates
for Interstate Navigation will return to the levels achieved in the year ended
5/31/03.

Automobile revenues will increase substantially once the Anna C begins
full-time service from Point Judith and the Carol Jean’s renovation is
complete. This will happen both because of the elimination of the competing
automobile service from New London and for all of the other reasons I cited.
The roughly 50% increase in automobile capacity, if fully utilized, would
result in an annual increase in revenues of approximately $685,000 if the increased capacity achieved the same utilization rates that are currently being achieved by the Intestate Navigation ferries from Point Judith. See Footnote [C] on Schedule JAR 2. For all of the reasons stated above, I estimate that the increased vehicle revenues due to the increased capacity for vehicles will be at least $500,000 and probably at least $100,000 more. To be conservative, my recommended rate increase is based upon an estimated $500,000 of revenues from the additional automobile capacity instead of the additional $174,000 estimated by the Company.
V. Cost of Capital

Q. HOW HAVE YOU DETERMINED THE COST OF CAPITAL IN THIS PROCEEDING?

A. I regularly testify as a cost of capital witness in utility rate proceedings. My most recently filed cost of capital testimony is in the South Jersey Gas rate proceeding that is currently before the New Jersey Board of Public Utilities. In that proceeding, I used a DCF method and a risk premium/CAPM method to support my cost of equity recommendation of 9.50%. The stock of Interstate Navigation is not publicly traded and there are no proxy group of ferryboat companies that could be used to provide a separate cost of equity quantification for Interstate Navigation. A gas utility comparison is reasonable because both ferry boat service to Block Island and the gas utility business are seasonal and weather dependent. The season for South Jersey Gas Company is the winter heating months. Furthermore, the amount of gas South Jersey sells during the heating season is highly dependent upon winter weather conditions. Interstate Navigation has a risk advantage over a gas company in being able to move its ferryboats to another location should business conditions warrant, while a gas company cannot economically move its pipelines and storage tanks.

For the above reasons, I have adopted the 9.50% cost of equity I recommended for South Jersey Gas Company as appropriate in this proceeding.

Q. SINCE YOU HAVE RECOMMENDED REDUCING THE RATE BASE ALLOWANCE FOR THE ANNA C DOWN TO ITS BOOK VALUE, SHOULD YOU ALSO EXCLUDE THE COMPANY PROPOSED $2.6 MILLION FROM CAPITALIZATION?
A. As long as the Company is actually going to obtain that financing, it could reasonably be viewed as part of the actual capitalization. Effectively, the debt that was obtained in excess of book value that was used to finance the purchase of the Anna C is a substitute for part of the company’s equity. Therefore, a strict interpretation of how to treat the financing of an asset in excess of its book value would be to reflect the debt on the balance sheet and to subtract a similar amount from the Company’s equity balance. However, making such an adjustment would place Interstate Navigation in the position of having a very thin common equity ratio. I will therefore be conservative and merely exclude the debt from the company’s capitalization rather than leave the debt in the capital structure and make a downward adjustment to common equity. Excluding this debt from the capitalization increases the revenue requirement because it increases the overall cost of capital.
VI. Rate Base

Q. PLEASE EXPLAIN HOW YOU OBTAINED YOUR RECOMMENDED RATE BASE.

A. I started with the rate base proposed by the Company. Division Witness Ms. Crane informed me that in prior rate cases, passengers paid for the cost of the Anna C based upon rate base, rate of return, operating expense computations. These computations included an allowance for the depreciation expense of the Anna C. Costs for the Anna C had already been established using rate base rate of return ratemaking. Therefore, it is improper for the cost basis used to charge passengers be suddenly increased even if the market value of the Anna C might be considerably higher than its net book value. I also adopted Ms. Crane’s recommendations on how to treat the cost of the Montville Dredging Project.

I noted that Mr. Edge made a request on behalf of the company for a working capital allowance of $655,054. His request is based in part on what he refers to as the 45 day “Rule” for working capital. See WEE 16. What needs to be understood is that this old-fashioned 45 day method is not a “rule”, but a guideline that used to be used in utility rate proceedings. Its original origin is that there is usually a 45 day lag between the time a utility company provides serviced to a ratepayer and the time a utility company is paid for that service. Utility companies typically read a meter once a month – causing a lag of an average of 15 days between the time service is rendered and a meter is read. Then, after reading a meter, a bill has to be prepared, mailed, received by a customer, paid and mailed back to the utility company, and deposited in the utility company’s bank. All of these later steps take an average of 30 days. This 30 day billing lag is added to the 15 day lag in reading the meter to arrive at the 45 day method. This 45-day method is largely rejected in current rate proceedings because it has
been recognized that in addition to lags in the collection of revenues, utility
companies also benefit from a lag in payment of expenses. However, considering
that there is no meter reading lag or billing lag associated with the provision of
ferry service, if the principles behind the 45-day “rule” were applied to Interstate
Navigation, the need for working capital would be zero. If more modern
modifications to the thinking behind the 45-day method were also considered,
then the working capital amount for Interstate Navigation would become negative
instead of positive.

A reading of the 5/31/03 balance sheet of Interstate Navigation (the most
current one provided) shows that as of 5/31/02 Interstate Navigation was using
$211,463 of working capital to finance Accounts Receivable, and $139,269 of
working capital to finance Prepaid Taxes and Expenses for a total of $350,732
of assets in need of working capital. The same balance sheet also shows that
working capital was being provided to the company through $325,775 of
Accounts Payable, $28,000 of Accrued Profit Sharing, and $129,996 of Deferred
Revenue, for a total of $483,771 of working capital being provided to Interstate
Navigation from its business operations to finance working capital. Since the
amount of working capital being provided to Interstate Navigation from its
business operations exceeds the amount of working capital it need to finance its
operations, at least on 5/31/02, Interstate Navigation actually had a negative
need for working capital – a result that is consistent with the zero need for
working capital predicted by the implementation of the principles supporting the
45-day method. I therefore recommend a zero allowance for working capital.

I adjusted the Company’s requested rate base to eliminate the $298,256
requested for “Capital Additions Projects”. The concept of setting rates based
upon an estimated rate year already gives the Company a forward-look at rate
base. Additionally, as I previously noted, the Company will be accruing over $1
million per year in its provision for depreciation. This annual provision for 
depreciation is considerably more than enough to finance $298,256 of future 
Capital Additions Projects.

The Company has failed to make any subtraction from rate base for 
deferred income taxes. Accumulated deferred income taxes are routinely 
subtracted from rate base because such taxes are a cost-free source of capital to 
the Company. Deferred income taxes arise when income taxes are paid by 
customers prior to the time that those taxes have to be paid to the Internal 
Revenue Service. This delay in the requirement to pay income taxes is often for 
many years and can be a meaningful source of funds to the Company. The 
Company acknowledged that it would have deferred taxes, but was unable to 
provide the amount. See the response to interrogatory #12 from the Town of 
New Shoreham Absent an accurate quantification from the Company, I have 
estimated that the Company has $978,722 of deferred income taxes. This 
estimate was prepared based upon a review of the books of Narragansett Electric 
Company. As of June 30, 2003, Narragansett Electric Company’s deferred 
income taxes were equal to 4.11% of its Gross Utility Plant. The average 
depreciable life used by Narragansett Electric on its assets is 29.67 years 
compared to 12.53 years for Interstate Navigation. Shorter depreciation life 
assets can have a higher deferred income tax balance compared to their original 
cost than longer-lived assets. I therefore have estimated that the provision for 
deferred income taxes applicable to Interstate Navigation as a percentage of 
assets is 50% higher than the one carried by Narragansett Electric. See Schedule 
JAR 9. I recognize that there could be many other differences between 
Narragansett Electric and Interstate Navigation which could make the actual 
deferred income tax balance higher or lower than I have estimated. If the 
Company provides the information necessary to determine its actual and rate
year pro-forma deferred income tax balance, I would review that submission and
if appropriate recommend using the actual number instead of the estimate I have
prepared.

The net result of the above recommendations is to lower the rate base from
the $11,465,520 requested by the Company down to $7,774,650. See my
Schedule 4.
VII Operating Expenses

Q. PLEASE EXPLAIN HOW YOU OBTAINED YOUR RECOMMENDED OPERATING EXPENSE.

A. I reviewed the rate year operating expense proposal made by the Company and made recommended adjustments to several that were extreme. The Commission may decide to make additional reductions beyond those I have proposed. Specifically, I lowered depreciation expense to exclude the depreciation on the Anna C for the same reasons that the Anna C investment was reduced in the computation of rate base; I lowered the request for an extraordinary increase to executive salaries and the associated increase in payroll tax because insufficient justification for such a large increase; I eliminated the additional request for advertising expense because additional advertising would only be a wise business decision if it were accompanied by more than enough of an increase in revenues to justify the increase; I eliminated the proposed increase in credit card processing expenses because there was no justification that the increase in credit card fees would continue indefinitely; I eliminated the proposed increase in telecommunications costs because there is no basis to expect costs will continue to increase just because there were large percentage increases in the past. Once the cost of having cellular telephones for the crew has been built into expenses, there is no remaining justification to expect these expenses to continue to increase in the future; and, as previously stated I have excluded the proposed increase in security costs and instead have proposed that the Company be
allowed to accumulate these costs and recover them in the future so that
recovery is based upon known costs rather than a highly unreliable estimate of
what those costs might be.
Q. IS IT APPROPRIATE FOR TICKET SALES TO SUMMER TOURISTS OR ANY OTHER OF THE FERRYBOAT SERVICES PROVIDED BY INTERSTATE NAVIGATION IN ITS SERVICE TO BLOCK ISLAND BE Deregulated?

A. No. Interstate Navigation operates the only service with the capacity to provide year round access to the Island for thousands of full time and summer residents and to deliver the goods and services necessary to sustain the economy and maintain life on the Island. Just because one other company is now providing a premium priced passenger and bicycle service aimed principally at non resident summer tourists does not change the unique and vital service being provided by Interstate Navigation nor does it alter the fact that Interstate has no significant competition in the bulk of its business. The service being provided by Interstate Navigation is still mostly a territorial monopoly that, without regulation, could be priced considerably above cost of service. Separating the round trip summer day tripper business from the other is not financially realistic.

Q. WHAT ARE THE NEW INITIATIVES BEING PROPOSED BY INTERSTATE NAVIGATION TO IMPROVE FERRYBOAT REVENUES?

A. New initiatives being considered by Interstate Navigation, include expanded advertising, group and mid-week fare discounts. If implemented, these plans could have an impact on future revenues, but the Company has failed to support
these proposed changes with any marketing plan. Furthermore, it has not even
provided any projection of any benefits that it feels may result from these
initiatives. Without a marketing plan, it is unknown if the proposed incentives
are likely to increase revenues or decrease revenues for Interstate Navigation.

Q. DOES INTERSTATE NAVIGATION LOSE MONEY BECAUSE IT
    PROVIDES OFF-SEASON SERVICE TO BLOCK ISLAND?

A. No. The full cost of Interstate Navigation’s service for the entire year is
    included in the determination of rates. Therefore, even IF it were true that the
    price of summertime service could go down if the off-season service were to be
    discontinued, such costs are not borne by Interstate Navigation, but are borne by
    the current passengers.

Q. IS THE COST OF PROVIDING OFF-SEASON SERVICE HIGH ENOUGH
    THAT IT IS SUBSIDIZED BY ON-SEASON SERVICE?

A. I do not know. Reaching such a conclusion would require an incremental cost
    study. An incremental cost study should exclude the fixed costs that the
    Company would have to incur to continue to provide in-season service. For
    example, the cost of the docks and the capital cost of the ferryboats would be
    incurred whether the boats are left in service or are taken out of service for the
    winter.
Q. DO YOU RECOMMEND THAT A COST STUDY BE DONE TO DETERMINE IF INTERSTATE NAVIGATION MAKES AN INCREMENTAL PROFIT ON ITS OFF-SEASON FERRY SERVICE?

A. No. Eliminating off-season service would have a long-reaching detrimental effect to the Island. If there were no off-season ferryboat service to Block Island, the value of the Island would deteriorate. Full-time residents could not continue to be full-time residents. The value of real-estate would decline because those with second homes on Block Island would find them less desirable to own if year-round access were denied. This decrement in the value and usefulness of Block Island would harm all those that depend on Block Island for recreation or income, including the Interstate Navigation Company.

Q. DOES INTERSTATE NAVIGATION PROVIDE LIFELINE SERVICE TO BLOCK ISLAND?

A. If the term lifeline service applies to any service that is sufficiently vital to the Island that its elimination would severely harm life as it is known on Block Island, the answer is yes. In addition to not being able to function without ferry service off-season, how could Block Island function without any operator providing a way for cars to get on and off the Island? How could Block Island function if the only passenger service was one high-speed ferryboat carrying no more than 250 passengers per trip? Life is sufficiently disrupted on Block Island when weather conditions force the canceling of ferryboat service for part of a
day showing that ferryboat service all-year round is a lifeline service to Block Island.

Q. IS IT PROPER FOR INTERSTATE NAVIGATION NOT TO OWN ASSETS THAT ARE PRIMARILY USED FOR THE PROVISION OF FERRYBOAT SERVICE TO BLOCK ISLAND AND ARE VITAL TO THE PROVISION OF THAT SERVICE?

A. I am concerned that selectively excluding vital pieces of what is necessary to provide ferryboat service, such as the docks on Block Island, could be a source of pricing abuse. Such abuse would be less likely if all of the vital assets to provide ferryboat service were owned by Interstate Navigation at prices reflective of what they would be if these assets had been owned by Interstate Navigation when they were originally acquired.

Q. IS A REAPPRAISAL OF THE CURRENT VALUE OF THE DOCK PROPER?

A. No. Rate of return regulation includes a return that already provides for an allowance for inflation. Providing a company with both a return on its investment that includes an allowance for inflation and also permits the company to earn a higher and higher return whenever the value of the property inflates provides an inappropriate duplicative allowance for inflation.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.
Appendix A - Testifying Experience of James A. Rothschild

TESTIFYING EXPERIENCE OF JAMES A. ROTHSCHILD
THROUGH FEBRUARY 29, 2004

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Connecticut Natural Gas, Docket No. 95-02-07, Rate of Return, June, 1995
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United Illuminating Company; Docket No. 99-02-04, Rate of Return, April, 1999
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DELAWARE

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Florida Power & Light Company; Docket No. 82007-EU, Rate of Return, June, 1982
Florida Power & Light Company; Docket No. 830465-EI, Rate of Return and CWIP, March, 1984
Florida Power & Light Company, Docket No. , Rate of Return, March 2002
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Florida Power Corp.; Rate of Return, August, 1986
Florida Power Corp.; Docket No. 870220-EI, Rate of Return, October, 1987
Florida Power Corp; Docket No. 000824-EI, Rate of Return, January, 2002
GTE Florida, Inc.; Docket No. 890216-TL, Rate of Return, July, 1989
Gulf Power Company; Docket No. 810136-EU, Rate of Return, October, 1981
Gulf Power Company; Docket No. 840086-EI, Rate of Return, August, 1984
Gulf Power Company; Docket No. 881167-EI, Rate of Return, 1989
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