State of Rhode Island and Providence Plantations

DEPARTMENT OF ATTORNEY GENERAL
150 South Main Street • Providence, RI 02903
(401) 274-4400
TDD (401) 453-0410

Patrick C. Lynch, Attorney General

January 19, 2006

VIA ELECTRONIC FILING

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

Re: **New England Gas Company;**
Distribution Adjustment Clause (DAC) Filing/
Docket No. 3690

Dear Ms Massaro:

Enclosed for filing on behalf of the Division of Public Utilities and Carriers is an original and nine (9) copies of the Direct Testimony and Exhibits of David J. Effron. Mr. Effron's testimony addresses New England Gas Company's calculation of the Earnings Sharing Mechanism (ESM) pursuant to the Settlement Agreement approved by the Commission in Docket No. 3401.

Thank you for your assistance in this regard.

Very truly yours,

Paul Roberti
Assistant Attorney General
Chief, Regulatory Unit

Enclosures

cc: Thomas F. Ahern, Administrator
Service List (Via Electronically and Regular Mail)

NEW ENGLAND GAS COMPANY

DISTRIBUTION ADJUSTMENT CLAUSE FILING

RIPUC DOCKET NO. 3690

BEFORE THE
RHODE ISLAND PUBLIC UTILITIES COMMISSION

TESTIMONY AND EXHIBITS
OF DAVID J. EFFRON

ON BEHALF OF THE

DIVISION OF
PUBLIC UTILITIES AND CARRIERS

JANUARY 19, 2006

RIPUC DOCKET NO. 3690
DIRECT TESTIMONY
OF DAVID J. EFFRON

TABLE OF CONTENTS

I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield, Connecticut.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty-five years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings?

A. I have analyzed numerous electric, gas, telephone, and water filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in over two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, Virginia, and Washington.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Rhode Island Division of Public Utilities and Carriers ("the Division").

Q. What is the purpose of your testimony?

A. On September 1, 2005, New England Gas Company ("NEG" or "the Company") filed its Earnings Sharing Calculation pursuant to the Commission's approval of the incentive based Earnings Sharing Mechanism ("ESM") contained in the Settlement Agreement in Docket 3401 ("Settlement"). The ESM Factor is a credit to the recoveries through the Distribution Adjustment Clause ("DAC"). The purpose of this testimony is to address the development of the ESM Factor to be included in the DAC.

Q. Please summarize your testimony.

A. NEG calculated excess revenue of $112,000 to be credited to the DAC. Based on my review and analysis of information provided by the Company, I have calculated that for the twelve months ended June 30, 2005, the excess revenue to be credited to the DAC is $612,000.

III. ESM CALCULATION

Q. Please describe the ESM Factor of the DAC.

A. The Settlement established a mechanism for sharing any annual earnings in excess of an 11.25% return on common equity for fiscal years subsequent to June 30, 2002 between customers and investors. In particular, Section II.F.5 of the Settlement specifies that:

> Any annual earnings over 11.25%, up to and including 100 basis points, shall be shared 50% to customers and 50% to the Company.

> Any earnings in excess of 12.25% shall be shared 75% to customers and 25% to the Company. In calculating the earnings subject to the ESM on an annual basis, the benchmark will remain at 11.25%, unless modified in a subsequent proceeding setting base rates to be effective on or after July 1, 2005. The customer share of any excess earnings will be passed through as a credit to the DAC.

Q. Did the Settlement specify how the return on equity should be calculated for the purpose of determining whether there were excess earnings to be credited to the DAC?

A. Yes. Section II.F.1 of the Settlement states:

> The return on common equity will be calculated by dividing the net income available for common equity by the common equity applicable to rate base; where the net income available for common equity is equal to operating income adjusted to reflect Commission ratemaking principles less applicable interest and preferred dividends (if any) …

Q. Has the Company prepared an analysis of its earned return on common equity for the twelve months ended June 30, 2005 ("FY2005")?

A. Yes. The Company calculated that earned a return on common equity of 11.39% in FY2005, resulting in a refund to customers of $112,000 (Attachment RJR-1, accompanying the testimony of Mr. Riccitelli).

Q. Have you examined the analysis conducted by the Company?

A. Yes. I have reviewed the return on common equity ("ROE) presented by the Company in Attachment RJR-1 to the direct testimony of Mr. Riccitelli. My examination included an analysis of the Company's financial statements for the twelve months ended June 30, 2005, workpapers supporting the return on equity calculation, and responses to requests for information.

Q. Based on your examination, should the Company's calculation of its earned ROE for FY2005 be modified?

A. Yes. There should be certain modifications to the Company's calculation of the earned return on common equity. My proposed modifications affect the determination of net income and the determination of common equity supporting rate base.

Q. Have you recalculated the earned return on equity and the ESM factor with your proposed modifications?

A. Yes. My calculation of the return on common equity earned by NEG in FY2005 is summarized on my Schedules DJE-1 and DJE-2. Schedule DJE-1 is a summary of the earned return on equity and the ESM Factor to be incorporated into the DAC. Schedule DJE-2 is my calculation of the net income (Pages 1 and 2) and rate base (Pages 3 and 4) to be used in the calculation of the earned return on common equity.

A. OPERATING INCOME

Q. Please explain Schedule DJE-2, Page 1.

A. On Schedule DJE-2, Page 1, I have begun in the first column with the net income available for common equity as calculated by the Company on Attachment RJR-1, Page 2. In the next column, I show my proposed adjustments; and in the third column, I show my calculation of the net income available for common equity. The adjustments to income are summarized Schedule DJE-2, Page 2. Each of these proposed adjustments affects operation and maintenance expense and, consequently, income tax expense.

1. OPERATION AND MAINTENANCE EXPENSE

a. Legal Fees

Q. What is your first proposed adjustment to operating income, related to legal fees?

A. In response to Division Data Request 2-13, the Company noted that fees for legal services rendered by Kaspwitz (sic), Benson, Torres & Friedman and by Watson, Bishop, Lathrop and Brophy, $150,136 and $73,183 respectively, should not have been included in the FY2005 ESM calculation. This adjustment eliminates those costs from operation and maintenance expenses included in the calculation of the earned return on equity.

b. Review of Health, Safety, and Environmental Policies

Q. What is the next adjustment, related to expenses incurred to conduct a comprehensive review of health, safety, and environmental policies in the twelve months ended June 30, 2005?

A. In FY2005, NEG undertook a review of its health, safety, and environmental policies. This examination was conducted pursuant to a directive by Southern Union Company's corporate legal counsel, at the request of the Board of

Directors. The stated purpose of the examination was to review all Company policies to assure consistency, where feasible, across all divisions and subsidiaries in critical compliance areas (response to Division Data Request 2-10). In association with this review, NEG incurred fees for legal and consulting services and costs to develop an up-to-date regulation and procedures manual. Based on the response to Division Data Request 1-17, the review resulted in increased expense of $574,000 in FY2005. The adjustment on Schedule DJE-2, Page 2 normalizes these costs by spreading them over three years, thereby eliminating two-thirds of the expense from the calculation of the earned return on equity for FY 2005.

Q. Why are you proposing to normalize this expense by spreading it over three years?

A. In response to Division Data Request 2-12, the Company stated that it anticipates such reviews of health, safety, and environmental policies to be "infrequent." Given the unusual and non-recurring nature of these costs and given that the costs relate to prospective operations of the Company, normalizing the costs over a period of more than one year is appropriate. I believe three years is a reasonable period over which the costs should be spread.

c. Supplemental Retirement

Q. Please explain the next adjustment, related to costs associated with the Southern Union supplemental retirement program.

A. In the second half of FY2005, Southern Union incurred $3,341,013 of supplemental retirement costs, which was substantially greater than the $172,674 incurred in the first half of FY2005. In response to Division Data Request 2-02, the Company explained that the plan was terminated in the second half of FY2005. As a result of the termination, it was necessary to book an accrual for future payouts related to the plan. The termination of the plan is expected to result in future savings.

Again, the cost associated with the termination of the supplemental retirement plan is a non-recurring expense, in this case an expense that is anticipated to produce future savings. Accordingly, the cost of the termination should be spread over a period of greater than one year. On my Schedule DJE-2, Page 2, I have spread the cost of terminating the supplemental retirement plan over three years. After allocation to NEG, this results in a reduction of $135,000 to operation and maintenance expense included in the calculation of FY2005 net operating income.

d. Mercury

Q. Did NEG incur costs related to a mercury release incident in FY2005?

A. Yes. In FY2005, NEG recorded costs of $8,640,000 related to the release of mercury from a Company-owned facility at the Tidewater site. These costs were charged to non-operating (sometimes referred to as or "below-the-line") expenses and were thus excluded from operating expenses for the purpose of the earnings sharing mechanism.

Q. Of what did these costs consist?

A. These costs consisted of clean-up and remediation costs, legal fees, security expenses, costs incurred to aid displaced persons, and Southern Union's project management and media relation activities (response to Division Data Request 1-17).

Q. Did the Company charge any time of local management or administrative personnel to non-operating expenses in association with the mercury release incident?

A. No. It is the Company's position that no such assignment or allocation is necessary, because the time devoted by New England Gas personnel was negligible and was, in effect, uncompensated overtime put in by salaried personnel outside of the time spent performing their regular jobs. Thus, the Company reasons, the mercury release incident did not require the allocation of any management or administrative salaries or expenses (response to Division Data Request 2-7).

Q. Do you believe that the assumption by the Company that no allocation of administrative and general expenses to the mercury release incident is appropriate?

A. No. First, given the magnitude of the problem (the $8.6 million is greater than the total amount spent on total distribution system maintenance in FY2005) it is difficult to believe that the NEG management and administrative personnel expended only minimal time and effort related to the mercury release event and that such time was put in only after their normal duties were completed. Second, many administrative and general responsibilities are by their nature not directly attributable to any particular activity; rather, the responsibilities relate to the company as a whole. In this regard, it should be noted that significant resources were devoted to addressing the mercury release incident, a New England Gas Company event, in FY2005.

Q. What do you recommend?

A. A review of the NEG operation and maintenance expenses in FY2005 does not indicate a substantial spike in expenses as a result of the mercury release incident. However, given the magnitude of the problem and the resources dedicated to resolving this matter, I believe that it is reasonable to allocate some share of administrative and general expenses to the activities associated with the mercury release incident. That is, as the administrative and general expenses cannot all be attributed to any particular activity, it is appropriate to allocate some portion of those expenses to activities as significant as those associated with addressing the mercury release event.

In particular, I believe that it is appropriate to allocate a portion Account 920 - Administrative and General Salaries (loaded for applicable pensions and benefits) and Account 921 - Office Supplies and Expenses, net of the credit for Administrative Expenses Transferred (Account 922), to the mercury release incident. I have summarized the expenses to be allocated on Schedule DJE-2, Page 2. As can be seen on this page, I have calculated net allocable expenses of $13,219,000.

I have also calculated the magnitude of the "below-the-line" mercury related expenses (after adjustment for legal fees that had been erroneously included in operating expenses, as noted above) in relation to total operation and maintenance expenses (including purchased gas), net of the expenses to be allocated, on Schedule DJE-2, Page 2. The mercury related expenses are 2.66% of the sum of the mercury related expenses plus the "above-the-line" net operation and maintenance expenses. Applying this 2.66% allocation factor to the allocable expenses of $13,219,000, the result is administrative and general expense of $352,000 being allocated to the mercury release incident. In my opinion, this is a reasonable allocation of administrative and general expense, and I have eliminated this expense from the calculation of the earned return on common equity.

2. INCOME TAX EXPENSE

Q. Please explain your adjustment to income tax expense.

A. The adjustment to income tax expense on Schedule DJE-2, Page 2 is derivative of the adjustments to operation and maintenance expense and interest expense. The adjustment to interest expense results from the adjustments to rate base described later.

3. NET INCOME

Q. What net income for available for common equity have you calculated?

A. I have calculated net income available for common equity of $12,773,000 (Schedule DJE-2, Page 1) for FY2005. This is the amount that should be divided by the balance of common equity applicable to rate base to determine the earned return on equity.

B. COMMON EQUITY

Q. Does the Settlement specify how the balance of common equity used in the earned return calculation should be determined?

A. Yes. Section II.F.1 of the Settlement states that in determining the earned return on equity:

> The common equity applicable to rate base shall be calculated by multiplying the actual common equity ratio, subject to the limitations in paragraph 2 below, by rate base. The rate base used in these calculations will be the average rate base for the relevant period, based on a five-quarter average and established Commission ratemaking principles.

Paragraph II.F.2 referred to in that section specifies that a common equity ratio of 43.6% will be used to calculate the common equity applicable to rate base during the Rate-Freeze period, July 1, 2002 – June 30, 2005.

Q. Are you proposing any adjustments to the rate base calculated by the Company for the purpose of determining the common equity balance to be used in the return on common equity calculation?

A. Yes. My calculation of rate base is shown on Schedule DJE-2, Page 3. My proposed adjustments to the rate base presented by the Company are shown on that schedule and on Schedule DJE-2, Page 4.

Q. What is your proposed adjustment to depreciation reserve?

A. One of the elements of the depreciation reserve is the unspent accrual for expected future environmental expenditures. In its revised response to Division Data Request 1-03, the Company noted an error in statement of the environmental accrual as of June 2004 on Attachment RJR-1, Page 5. Correction of the error in the accrual as of June 2004 diminishes the average depreciation reserve for FY 2005 by $1,101,000.

Q. What is your next adjustment to rate base on Schedule DJE-2, Page 4, related to accumulated deferred income taxes (ADIT)?

A. The Company's calculation of the average balance of ADIT in FY2005 is shown on Attachment RJR-2. The calculation forecasts a decrease in the balance of ADIT in the last six months of FY 2005. I do not believe that the Company has provided adequate support to conclude that it is likely that such a decrease will actually be taking place. In addition, it can be seen on Attachment RJR-2 that in each of three prior fiscal years there has been a subsequent true-up that has increased the balance of ADIT.

I have adjusted ADIT by assuming that the balance would not decrease in the last six months and that the subsequent accrual true-up would be equal to the average for the last three fiscal years. With these two modifications, I have calculated an increase of $309,000 to the balance of ADIT deducted from plant in service in the determination of rate base.

Q. With your proposed adjustments, what rate base have you calculated?

A. I have calculated a rate base of $244,189,000 (Schedule DJE-2, Page 3).

Q. What balance of common equity have you calculated?

A. Applying the common equity ratio of 43.6% specified in the Settlement to the rate base of $244,189,000, I have calculated a balance of common equity of $106,466,000 (Schedule DJE-1).

C. RETURN ON COMMON EQUITY

Q. With the above changes to the net income available for common equity and the balance of common equity, what return on common equity have you calculated for FY2005?

A. With the modifications described above, I have calculated that NEG Gas earned a 12.00% return on common equity in FY2005 (Schedule DJE-1).

D. ESM FACTOR

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

A. Yes, I have calculated excess revenue of $612,000 on Schedule DJE-1. This calculation is in the same format as Appendix C to the Settlement.

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

A. Yes. Based on sales of 357,678,000 therms, the ESM Factor included in the DAC would be $0.0017 per therm (Schedule DJE-1).

Q. Does this conclude your direct testimony?

A. Yes.

NEW ENGLAND GAS COMPANY
CALCULATION OF EARNINGS SHARING
($000)

1	Net Income Available for Common Equity	$ 12,773
2	Common Equity Supporting Rate Base	106,466
3	Earned Return on Common Equity	12.00%
4	Benchmark Return on Common Equity	11.25%
5	Return on Equity above Benchmark	0.75%
6	Earnings above Benchmark	796
7	Company Share of Earnings above Benchmark - 50/50 Sharing	398
8	Company Share of Earnings above Benchmark - 75/25 Sharing	-
9	Ratepayer Share of Earnings above Benchmark	398
10	Revenue to be Refunded	$ 612
11	Firm Throughput (000 Therms)	357,678
12	Earnings Sharing Factor ($/therm)	$ 0.0017

Line Notes

1	Net Income Available for Common Equity		DJE-2, Page 1
2	Rate Base	$244,189	DJE-2, Page 3
	Common Equity Ratio	43.60%	DJE-2, Page 4
	Common Equity Supporting Rate Base	$ 106,466	
3	Line 1 / Line 2		
4	Per Settlement		
5	Line 3 - Line 4		
6	Line 5 * Line 2		
7	Line 5 (up to 1.00%) * Line 2 / 2, not Less than Zero		
8	((Line 5 - 1.00%)*Line 2)/4, not Less than Zero		
9	Line 6 - Line 7 - Line 8		
10	Line 9 /.65 (1- Tax Rate)		
11	Attachment PCC-3		
12	Line 10 / Line 11		

Schedule DJE-2
Page 1

NEW ENGLAND GAS COMPANY
RESULTS OF OPERATIONS
YEAR ENDED JUNE 30, 2005
($000)

	(1) Company Position	Adjustments		Division Position
Revenue	$410,616			$ 410,616
Operation and Maintenance Expense	339,053	(1,092)	(2)	337,961
Depreciation and Amortization	20,753			20,753
Other Taxes	22,243			22,243
Income Taxes	6,754	372	(2)	7,126
Operating Expenses	388,803	(721)		388,083
Operating Income	21,813	721		22,533
Interest on Short-Term Debt	671	2	(3)	673
Interest on Long-Term Debt	8,687	29	(3)	8,716
Other Interest	118			118
AFUDC	(207)	-		(207)
Total Interest Expense	9,269	30		9,299
Net Income	12,544	690		13,234
Preferred Dividends	459	2	(3)	461
Net Income for Common Equity	$ 12,085	$ 688		$ 12,773

Sources:

(1)	Attachment RJR-1, Page 2			
(2)	Schedule DJE-2, Page 2			
(3)	Rate Base		$244,189	DJE-2, Page 3
	Interest on Short-Term Debt	0.28%	673	DJE-2, Page 5
	Interest on Long-Term Debt	3.57%	8,716	DJE-2, Page 5
	Preferred Dividends	0.19%	461	DJE-2, Page 5

NEW ENGLAND GAS COMPANY
DIVISION ADJUSTMENTS TO INCOME
YEAR ENDED JUNE 30, 2005
($000)

Operation and Maintenance Expense:			
Legal Fees		(1)	(223)
Comprehensive Review - Health, Safety & Environmental		(2)	(383)
Southern Union - Supplemental Retirement		(3)	(135)
Mercury		(4)	(352)
Total Adjustment to Operation and Maintenance			(1,092)
Income Taxes:			
Revenue	(5)		410,616
Operating Expenses	(5)		380,957
Interest	(5)		9,299
Taxable Income			20,360
Income Tax Expense	35%		7,126

Sources:

(1)	Response to DIV 2-13	(150+73)	
(2)	Response to DIV 1-17	2/3*574	
(3)	Response to DIV 1-05	(173-3341)*2/3*2323/36335	
(4)			

Administrative and General Salaries	RJR-4, Page 325	9,814
Employee P&B Allocated to A&G Salaries	RJR-4, Pages 325, 355	4,330
	9814/37100*16370	
Office Supplies and Expenses	RJR-4, Page 325	3,093
Administrative Expenses Transferred	RJR-4, Page 325	(4,018)
Total Expenses Subject to Allocation		13,219
"Below the Line" Mercury, as Adjusted	RJR-1, Page 9 + 223 above	8,863
Total O&M, net of Costs to be Allocated	RJR-4, Page 114	324,402
Total		333,265
Mercury Costs as Percentage of Total		2.66%
Adjustment to Expenses		352

(5) Schedule DJE-2, Page 1

NEW ENGLAND GAS COMPANY
RATE BASE
YEAR ENDED JUNE 30, 2005
($000)

	(1) Company Position	Adjustments		Division Position
Utility Plant in Service	$501,152			$501,152
Less- Reserve for Depreciation	(232,758)	1,101	(2)	(231,657)
Net Plant	$268,394	$1,101		$269,495
Add:				
Materials & Supplies	2,105			2,105
Prepaid Expenses	480			480
Deferred Debits	2,460			2,460
Gas Inventories	-			-
Cash Working Capital	12,190			12,190
Deduct:				
Accumulated Deferred FIT	(35,160)	(309)	(3)	(35,469)
Accumulated Deferred ITC	(1,542)			(1,542)
Contributions in Aid of Construction	(1,162)			(1,162)
Customer Deposits	(2,869)			(2,869)
Injury and Damages Reserve	(1,499)	-		(1,499)
Rate Base	$243,397	$792		$244,189

Source:
(1) Attachment RJR-1, Page 5
(2) Response to DIV 1-03, Revised
(3) Schedule DJE-2, Page 4

NEW ENGLAND GAS COMPANY
RATE BASE ADJUSTMENTS
YEAR ENDED JUNE 30, 2005
($000)

Accumulated Deferred FIT			
Balance	Jun-04	(1)	33,749
	Sep-04	(2)	34,802
	Dec-04	(3)	35,855
	Mar-05	(3)	35,855
	Jun-05	(3)	35,855
Average Balance			35,223
Adjustment for Accrual True-Up		(4)	246
Adjusted Average Balance			35,469

Sources:

(1)	Attachment RJR-2	
(2)	Attachment RJR-2	33,749+2106/2
(3)	Attachment RJR-2	33,749+2106
(4)	Attachment RJR-2	(165+408+165)/3

NEW ENGLAND GAS COMPANY
RATE OF RETURN

	Ratio	Cost Rate	Wtd. Cost
Short Term Debt	8.80%	3.13%	0.28%
Long Term Debt	45.70%	7.81%	3.57%
Preferred Stock	1.90%	9.93%	0.19%
Common Equity	43.60%	11.25%	4.91%
Total	100.00%		8.94%

Source: Settlement, Section II.F
Attachment RJR-1, Page 10 for Short Term Debt Rate