STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: NARRAGANSETT BAY COMMISSION :
ABBREVIATED APPLICATION FOR RATE RELIEF : DOCKET NO. 3707

REPORT AND ORDER

On November 1, 2005, the Narragansett Bay Commission ("NBC") filed with the Rhode Island Public Utilities Commission ("Commission") an abbreviated application for rate relief seeking an increase to its existing rate schedule to become effective on June 1, 2006.[1] The proposed rates were designed to generate total revenues of $64,040,242 and if approved as filed, would increase NBC's present revenues by $3,108,471 or 5.1%.

The instant abbreviated rate case filing represents NBC's sixth rate filing in the last six years. This abbreviated rate case filing does not relate to debt service for the Combined Sewer Overflow Abatement Program ("CSO"). The following provides a brief history:

DOCKET NO.	FILING DATE	INCREASE REQUESTED	INCREASE ALLOWED	AUTHORIZED REVENUE
3162	6/29/00	$10,089,441	$ 6,669,489	$36,632,209
3409	12/21/01	$ 8,834,420	$ 8,834,420	$45,467,359
3483	11/29/02	$13,826,248	$ 7,047,965	$51,499,178
3592	3/1/04	$ 4,967,683	$ 2,883,974	$54,380,549
3639	10/4/04	$ 6,551,225	$ 6,551,225	$60,931,773
3707	11/1/05	$ 3,108,471		

I. NBC

On November 1, 2005, NBC submitted pre-filed testimony by Walter Edge, an outside consultant. In his prefiled testimony, Mr. Edge indicated that the abbreviated rate filing encompasses personnel expenses and operating costs, but does not include debt

[1] In subsequent filings, NBC amended the effective date for the rate increase to July 1, 2006 (11/9/05).

service. Mr. Edge utilized the rate year approved in Docket No. 3639 as the test year.[2] Mr. Edge made no adjustments to the test year. Mr. Edge indicated that NBC was not seeking an increase for either salaries or debt service. He noted that the most significant increase in the filing was for the outsourcing of all biosolids (sludge) disposal. The outsourcing of sludge disposal will result in a net increase of $1,507,485 from $2,745,460 to $4,252,945. The outsourcing of sludge disposal eliminates six expense accounts, which are solids handling repairs, oil for solids handling, gas for solids handling, lime polymer, and supplies for solids handling. There is also a reduction in the electricity account. Mr. Edge mentioned that the accounts for salaries and overtime would be impacted but did not include the reduction.[3]

In personnel expenses, Mr. Edge projected an increase in the employee retirement benefit for union pensions of $291,797. Mr. Edge explained that NBC's union employees are participants in the State of Rhode Island pension plan and that the State of Rhode Island has increased the employer contribution rate significantly over the past few years. In addition, Mr. Edge calculated an increase in the cost of health care benefits of $445,429, which is based on the average percentage increase in health care premiums for the previous three years.[4]

As for energy costs, Mr. Edge projected an increase in natural gas costs of $185,874 based on pricing information from NBC's suppliers, Select Energy and New England Gas. In addition, Mr. Edge projected an increase in electricity costs of

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[2] On October 6, 2005, NBC filed a motion with the Commission requesting authorization to use the rate year as the test year in the next abbreviated rate filing. With two conditions, the Division concurred with the request on October 17, 2005. At an open meeting on October 20, 2005, the Commission approved NBC's request with the Division's two conditions.
[3] NBC Ex. 1 (Edge's direct testimony), pp. 1-4.
[4] Id., pp. 4-5.

$445,784. This calculation is based on the electric supply rates for the next four years, beginning January 1, 2006, of $0.07195 per kWh.[5]

In regards to Bucklin Point, Mr. Edge explained that, as a result of a competitive bid, NBC entered a new management contract for the Bucklin Point facility. The new contract requires the contractor to pay for two chemicals. Overall, Mr. Edge projected a net increase for $43,969 for management of Bucklin Point.[6]

Furthermore, Mr. Edge discussed that NBC would not need an increase in debt service for fiscal year 2007 because NBC's debt service allowance approved in Docket No. 3639 is $25,872,877, but the rate year debt service is slightly more than $23 million. He explained that this occurred because: NBC defeased its share of all outstanding state debt; NBC issued $45 million in revenue bonds for a 30 year term rather than a 20 year term; and NBC worked with the Rhode Island Clean Water Finance Agency ("RICWFA") to structure its proposed bond issuance such that all coverage requirements can be met without a revenue increase in 2007 for debt service.

Lastly, Mr. Edge discussed that NBC would not need an increase in salaries. Although Mr. Edge calculated a rate year increase of $931,848 based on contracted union increases and expected non-union increases, he calculated savings in salaries and overtime of $338,724 as a result of outsourcing sludge handling, and Mr. Edge determined that not all of the positions approved in the last docket are filled. In conclusion, Mr. Edge declared that even if all employee positions are filled and the

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[5] Id., p. 5.
[6] Id., p. 6.

sludge handling savings are not enough to cover the salary increases, NBC will balance its budget for fiscal year 2007 through strong financial management.[7]

II. DIVISION

On February 8, 2006, the Division of Public Utilities and Carriers ("Division") submitted the pre-filed testimonies of Thomas Catlin, an outside consultant, and David Stearns, a Public Utilities Analyst V for the Division. Mr. Catlin recommended a revenue increase of $2,036,547 or 3.3%. In the area of revenues, Mr. Catlin adjusted NBC's user fee revenue by increasing it by $3,746 to reflect the revenue level approved in Docket No. 3639. Also, Mr. Catlin adjusted NBC's interest income by increasing it by $669,366 to $914,079. Mr. Catlin noted that NBC recognized $244,713 of interest income, which was the total actual interest income in fiscal year 2002. However, he explained that the total NBC interest income was $914,079 in fiscal year 2005. He indicated that this interest income coincides with a build-up of the restricted account balance for debt service payments. He noted that NBC suggested that interest earned on the restricted debt service/capital account balance can not used to offset the cost of service since such interest must be retained in the restricted accounts according to the Trust Indenture. Mr. Catlin disagreed with NBC's viewpoint. He stated that total interest on restricted debt service/capital account has been recognized as an offset to the cost of service in the past. Also, he indicated that the Trust Indenture does not require the interest income earned on restricted account balances to be retained in those accounts.[8]

In the area of personnel expenses, Mr. Catlin first discussed the union pension expense. He adjusted the NBC employer contribution rate to the union pension plan from

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[7] Id. pp. 6-11.
[8] Div. Ex. 1 (Catlin's direct testimony), pp. 1-9.

17.17% as filed to 18.4%, which will be the actual rate for the rate year. However, Mr. Catlin capitalized a portion of employee benefits for those employees who charge their time to capital construction projects. As a result, Mr. Catlin recommended a net increase in Operation and Maintenance ("O&M") expense of $320,260 or $28,463 more than filed by NBC. As for health insurance, Mr. Catlin explained that NBC's projection for medical insurance in fiscal year 2007 is based on 250 employees with the medical insurance annual premium for fiscal year 2006 escalated by the average annual increase over the last three years. In contrast, Mr. Catlin used a two year average annual increase in medical insurance premium, which is a 7 to 9 percent increase per year instead of the 13.4 to 15.6 percent increase as projected by NBC. Also, Mr. Catlin reduced the number of employees from 250 to 246, which is based on 242 employees as of December 2, 2005 and four positions to reflect turnover. In addition, Mr. Catlin reduced the health insurance premiums to recognize the co-payments by employees of $8,727 although "the amount of such co-payments is small". Lastly, he recognized 9.5 percent of health insurance premium increases to be charged to capital projects. As a result, Mr. Catlin projected a net increase of $252,303 in health insurance related to O & M expense, which is $193,126 less than claimed by NBC.[9]

Regarding utility expenses, Mr. Catlin incorporated Mr. Stearns' adjustment to NBC's electric costs by reducing NBC's request by $63,932. In addition, Mr. Catlin determined that NBC only reduced the incinerator electric cost by $142,194. Mr. Catlin noted that Mr. Stearns reduced the delivery rate for Field's Point from $0.028 per kWh to $0.02738 per kWh. As a result, Mr. Catlin concluded the electric costs included for the Field's Point incinerator should be $205,279, and therefore, an adjustment to fully

[9] Id., pp. 9-13.

remove these costs is $63,085 more than the $142,194 removed by NBC from the rate year. Also, as to natural gas costs, Mr. Catlin noted that NBC had not entered into a new gas supply contract to begin on March 2006, and indicated that the Select Energy proposed prices were well in excess of New England Gas Company's gas cost rate. Thus, Mr. Catlin adjusted NBC's claimed cost of gas to reflect New England Gas Company's rate of $1.197 per therm with a 4 percent increase on November 1, 2006. In addition, he adjusted the Rhode Island Gross Earnings Tax for gas from 4 percent to 3 percent. In total, Mr. Catlin reduced NBC's gas costs by $37,421.[10]

Furthermore, Mr. Catlin noted that hypochlorite is utilized at Field's Point and in interceptor maintenance ("IM"). However, he indicated that Bucklin Point hypochlorite costs were $83,252 in fiscal year 2004 and $96,065 in fiscal year 2005 compared to the $20,117 removed by NBC. Also, he noted that NBC claimed hypochlorite costs of $369,705 when the actual hypochlorite costs for Field's Point and IM were $306,483 in fiscal year 2004 and $305,578 in fiscal year 2005. As a result, Mr. Catlin used the average cost in fiscal years 2004 and 2005 for Field's Point and IM to develop a rate year allowance of $306,031 for hypochlorite, which is $63,675 less than NBC's request. Lastly, Mr. Catlin agreed with NBC's proposal for increasing rates on an across-the-board basis.[11]

In his pre-filed testimony, Mr. Stearns discussed NBC's electric costs. Mr. Stearns explained that NBC calculated its electric costs by dividing total electricity charges by total kWh consumed instead of using the actual electric delivery rates. Also, NBC's average kWh cost was carried to three decimal places, after rounding. In contrast,

[10] Id., pp. 13-17.
[11] Id., pp. 17-19.

Mr. Stearns calculated NBC's electric costs by utilizing Narragansett Electric's actual delivery charge carried out to five decimal places as well as the actual average electric usage during fiscal years 2004 and 2005 with the exception of Bucklin Point which is an estimate since new equipment with high electricity demand was installed. As a result, Mr. Stearns reduced NBC's projected costs by $63,932.[12]

III. NBC's REBUTTAL

On March 1, 2006, NBC submitted the rebuttal testimony of Mr. Edge. Mr. Edge agreed with most of the testimony of Mr. Catlin and Mr. Stearns. For instance, Mr. Edge agreed with Mr. Catlin's adjustment to increase residential measured user fees by $3,746. However, Mr. Edge disagreed that a portion of the union pension account should be capitalized. He noted that none of the 13.9 FTEs charged to the CIP projects are union personnel. Thus, Mr. Edge added $33,618 back to Mr. Catlin's pension expense with a resulting increase to personnel costs of $62,081. Regarding Mr. Stearns' electricity adjustments, Mr. Edge expressed concern that Mr. Stearns' estimate for kilowatt hours in the filing are too low. He stated that if Mr. Stearns' rounding adjustment is accepted, the estimated total kilowatt hours for Bucklin Point should be increased as well. As for natural gas costs, Mr. Edge noted that recent gas supply bids accepted by NBC were lower than Mr. Catlin's projection. As a result, Mr. Edge reduced the rate year expense for natural gas by $63,229.[13]

For health care expenses, Mr. Edge accepted Mr. Catlin's adjustment for the number of employees, inclusion of co-payments for new employees, and capital reimbursement factor. However, Mr. Edge did not agree to use Mr. Catlin's two year

[12] Div. Ex. 3 (Stearn's direct testimony), pp. 2-5.
[13] NBC Ex. 2 (Edge's rebuttal) pp. 1-3.

average for the health insurance percentage increase. Mr. Edge explained that a 13.43% increase is a conservative rate increase, which was the three year average increase for PPO family coverage. He noted that based on NBC's preliminary discussions with its health insurer, a 13.43% projected increase is realistic. He also stated that the higher percentage in claims loss in 2006 will result in a much higher health insurance premium increase in the rate year compared to prior years. As a result, Mr. Edge reduced NBC's requested increase for health care benefits by $58,355. Mr. Edge also disagreed with Mr. Catlin's use of interest income earned from restricted accounts to offset O&M expense and noted that in bond counsel's opinion, NBC is clearly prohibited from transferring interest income from the Project Fund to fund O&M expense. Regarding hypochlorite costs, Mr. Edge disagreed with Mr. Catlin's adjustment and instead recommended using the current rates for hypochlorite multiplied by the usage at Field's point and IM. As a result, Mr. Edge reduced NBC's request for hypochlorite cost by $8,229. In conclusion, NBC reduced its filed increase by $136,525 in its rebuttal position.[14]

IV. <u>DIVISION'S SURREBUTTAL</u>

On March 22, 2006, the Division submitted surrebuttal testimony by Mr. Catlin and Mr. Stearns. In his pre-filed surrebuttal testimony, Mr. Catlin agreed to NBC's proposed level of interest income for the ratepayer out of concern that inclusion of interest income could be regarded negatively by bondholders. However, he did recommend that the issue be examined more fully in NBC's next base rate filing. Mr. Catlin agreed to exclude union pension costs as well as Workers Comp—Old Claims, from the calculation of benefit costs capitalized. However, Mr. Catlin noted that the

[14] <u>Id</u>., pp. 3-6.

actual percentage of benefit costs capitalized in fiscal year 2005 was 10.67 percent of all benefit costs, and after excluding union pension costs and Workers Comp—Old Claims, the percentage increased to 12.14 percent. This resulted in an increase of $56,331 in the amounts capitalized compared to the $476,292 allowance in NBC's filing. In addition, Mr. Catlin's adjustment to union pension expense does not differ from Mr. Edge's rebuttal testimony.[15]

As for health insurance costs, Mr. Catlin disagreed with NBC's rebuttal position. He noted that the claims loss ratio is only one factor that affects insurance premiums. He emphasized that projected medical insurance premiums for fiscal year 2007 are only projections. He stressed that "rather than simply accepting those increases as inevitable, NBC should be instituting measures to control those costs." He used as examples: "increasing deductibles and/or co-pays for doctor visits; seeking bids from alternative insurers; utilizing different plans offered by existing insurers; and increasing the amount that employees must contribute toward premiums." He noted that only new employees hired after June 30, 2004 are required to make any contribution toward medical insurance premiums and it reflects only 0.3 percent of total medical insurance premiums for the rate year. As a result, Mr. Catlin continued to reflect increases of 7.28 percent for PPO coverage and 8.46 percent for HMO coverage. He also used the updated capitalization ratio of 12.14 percent, which reduced NBC's rebuttal claim for health benefit costs by $142,119.[16]

As for other operating expenses, Mr. Catlin noted that NBC did not claim Mr. Stearns' calculation for electric costs was incorrect. He noted that Narragansett Electric

[15] Div. Ex. 3 (Catlin's surrebuttal testimony), pp. 1-5.
[16] Id., pp. 5-7.

uses five decimal places in billing NBC for delivery service. Also, Mr. Catlin explained that NBC identified 14.15 million kWh as a cap on the electrical usage that Aquarion can pass through to NBC for Aquarion to operate Bucklin Point. Since 14.15 million kWh is the amount included in NBC's filing for Bucklin Point, Mr. Edge's argument that electric usage for Bucklin Point should be increased is spurious. Accordingly, Mr. Catlin indicated that the Division's surrebuttal position for electrical costs is $109,786 less than NBC's rebuttal filing. As for natural gas costs, Mr. Catlin noted a small discrepancy in NBC's rebuttal position and indicated that the natural gas supply rate in the new contract with Amerada Hess is $1.1503 per therm rather than $1.153 per therm provided in the testimony. As a result, Mr. Catlin reduced the natural gas costs by an additional $918. Also, Mr. Catlin accepted NBC's rebuttal position for hypochlorite costs. In conclusion, Mr. Catlin stated that he recommended an increase of $2,661,755, a 4.60 percent increase in rates, or $313,937 less than NBC's surrebuttal position.[17]

In his pre-filed surrebuttal testimony, Mr. Stearns noted that in Docket No. 3483 the Commission utilized electric rates rounded to five places to develop NBC's electric expenses. He also noted that the 14.15 million kWh estimate for Bucklin Point was provided by NBC, and he discussed NBC's contract for Bucklin Point whereby Aquarion is responsible for electric usage over 14.15 million kWh. Also, Mr. Stearns reduced NBC's electric costs to reflect a decrease in Narragansett Electric's transition and transmission rates effective January 1, 2006. In total, Mr. Stearns reduced the electric costs stated in NBC's rebuttal position by $109,786.[18]

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[17] Id., pp. 7-10.
[18] Div. Ex. 4 (Stearns' surrebuttal testimony), pp. 1-4.

V. SETTLEMENT AND HEARING

On April 6, 2006, NBC and the Division filed a Settlement Agreement with the Commission. The parties agreed to adopt the position set forth in Mr. Catlin's surrebuttal testimony. As a result, the parties agreed to a revenue increase of $2,658,009 or 4.60% over present rates.[19]

After published notice, the Commission conducted a public hearing on April 10, 2006 at the Commission's offices at 89 Jefferson Boulevard, Warwick, Rhode Island. The following appearances were entered:

FOR NBC:	Peter McGinn, Esq.
FOR THE DIVISION:	Leo Wold, Esq. Special Assistant Attorney General
FOR THE COMMISSION:	Steven Frias, Esq. Executive Counsel

The parties presented a panel of witnesses, which included Mr. Walter Edge, Mr. Thomas Catlin and Mr. David Stearns. Mr. Catlin explained that the 246 employee positions used to calculate healthcare premiums is based on a turnover allowance of three employees and the actual number of 243 NBC employees.[20] In regards to co-sharing of health care premiums, Mr. Edge admitted NBC's management has the ability to require any level of co-payment by non-union employees with the exception of some who may be under contract. He also acknowledged that more employers are requiring their employees to pay for a portion of their health care premiums. He also indicated that NBC is in the process of reopening union negotiations for health insurance and is looking

[19] Joint Ex. 1 (Settlement Agreement).
[20] Tr. 4/10/06, pp. 14-15.

at the opportunity to implement a co-pay from its non-union employees.[21] Mr. Edge stated that the major reason NBC's spending for the last four years has been below what NBC actually budgeted is due to the Commission. He explained that NBC budgets all of the employee positions it desires, but since the Commission does not fund all these positions in rates, this results in a large variance in salaries and wages. In essence, Mr. Edge noted that the Commission sets rates that are lower than the revenues established in NBC's budget.[22] As for the operating reserve, Mr. Catlin concurred that NBC derives less of its revenues from consumption than other water utilities and more from fixed rates. When Mr. Edge was asked what his objection would be to lowering NBC's operating reserve, Mr. Edge responded that he has "no objection to whatever percentage this Commission decides is an appropriate percentage" for an operating reserve but noted that 1.5% has generally been used. He also concurred that a utility is not entitled to an operating reserve through rates unless approved by the Commission.[23]

VI. POST HEARING DEVELOPMENTS

On April 13, 2006, NBC provided responses to the Commission's record requests as well as data responses made in response to Commission data requests arising from public comment at the hearing. On May 16, 2006, NBC provided responses to additional Commission data requests. At an open meeting, on May 25, 2006, the Commission reviewed the evidence presented. The Commission decided to modify the Settlement by reducing NBC's revenue requirement as set forth in the Settlement Agreement by $248,746 to reflect the equivalent of a co-payment of 10% of health care premiums by NBC employees. It was also noted that if NBC did not agree to this modification, this

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[21] Id., pp. 19-20.
[22] Id., pp. 23-26.
[23] Id., pp. 30-32.

would necessitate a hearing to discuss the co-payment issue as well as NBC's operating reserve. In addition, a majority of the Commission discontinued funding for the CSO Overseer position and instead only maintained $150,000 with the remainder flowing back to debt service/capital accounts. On June 5, 2006, NBC filed a response to the Commission objecting to the modification to the Settlement. As a result, a pre-hearing conference was convened and a hearing on NBC's rate filing was scheduled for June 19, 2006. At the pre-hearing conference, NBC indicated that it still agreed with the Division's surrebuttal cost of service position.

VII. ADDITIONAL HEARING

After notice, the Commission conducted a public hearing on June 19, 2006 at the Commission's offices at 89 Jefferson Boulevard, Warwick, Rhode Island. The following appearances were entered:

FOR NBC:	Peter McGinn, Esq.
FOR THE DIVISION:	Leo Wold, Esq. Special Assistant Attorney General
FOR THE COMMISSION:	Steven Frias, Esq. Executive Counsel

On June 19, 2006, NBC presented Mr. Vincent Ragosta, NBC's labor attorney, and Mr. Edge as their witnesses. Mr. Ragosta discussed in general NBC's collective bargaining with its labor unions. For instance, Mr. Ragosta indicated that NBC's collective bargaining agreements have significant management prerogatives.[24] He explained that NBC and its unions had reached an agreement to require all union NBC employees to do a co-pay of their health insurance premium. He noted that this co-pay would also be applied to all of NBC's non-union employees. Mr. Ragosta was optimistic

[24] Tr. 6/19/06, pp. 18-21.

that the new agreement regarding health care would be approved by the membership of the unions, and indicated that the tentative agreement with the union had already been approved by NBC's Board of Governors.[25]

Under cross-examination, Mr. Ragosta stated that in the private sector it is not uncommon for union employees to pay a co-share of premiums between five to ten percent and for non-union employees to have a co-share as high as 50 percent. He agreed that in the public sector it is becoming more common for public sector employees to pay a co-share health insurance premiums. Mr. Ragosta acknowledged that some public sector employers require a different co-share from non-union employees than from union employers. Also, Mr. Ragosta stated that regardless of the collective bargaining agreement, NBC could legally require its non-union employees to co-pay their health insurance premiums.[26]

Mr. Edge indicated that NBC agrees with the Division's surrebuttal position on the total cost of service. However, he noted that NBC felt the electric calculations were incorrect by $57,588; the workers' compensation expense will be $70,000 higher; and that the PUC assessment is $60,000 higher than as set forth in NBC's cost of service. However, he admitted that in budgeting "you tend to find out the bad news before you find out the good news" and that "there may be savings through the year". Mr. Edge calculated $70,116 as the savings from implementation of the proposed co-pay for NBC employees.[27]

Under cross-examination, Mr. Edge stated NBC would not file for a rate increase for the amount of $468,000, the size of the proposed operating reserve, but instead NBC

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[25] Id., pp. 24-29.
[26] Id., pp. 30, 32-36.
[27] Id., pp. 55-57, 62-63.

would "figure out a way to offset it" through cost savings elsewhere. He acknowledged that the amount of the PUC assessment in the cost of service was based on the test year proposed by NBC. Also, Mr. Edge agreed that the Division has not had the opportunity to review the alleged potential increased expenses discussed by Mr. Edge at the hearing since NBC did not request them it in the rate filing. Mr. Edge did acknowledge that not filling positions can create cost savings and noted that the Division already recommended a turnover allowance. When asked where a utility finds cost savings he stated that "not everything is going to go over budget" and that "we expect there will be savings." Specifically, he mentioned reducing capital additions, supplies or inventory as areas for potential cost savings. Mr. Edge did acknowledge that the operating reserve for a utility is a discretionary decision by the Commission and agreed that in the past the Commission has reduced NBC's operating reserve. He also noted that there have "been a lot of changes in the net operating reserve" since he was employed by the Division. He explained that in the past, utilities received an operating reserve based on 1.5 percent of all expenses, but now it does not include debt service since it is a known expense. In addition, Mr. Edge stated that he was not sure the NBC budget, approved by NBC's Board of Governors, specifically has an operating reserve.[28]

After the hearing, the Commission received NBC's record responses, including a response indicating that "the operating reserve is not included as a separate line item in the budget".[29] At an open meeting on June 22, 2006, the Commission adopted the Division's surrebuttal positions with two modifications. First, the Commission reduced the proposed rate increase by $70,116 to reflect the proposed employee co-share of health

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[28] Id., pp. 58, 69-71, 73-77.

[29] NBC's PUC Rec. Resp. 3 (6/21/06).

care premiums. Second, a majority of the Commission reduced NBC's operating reserve by $239,271 by excluding personnel costs from the base for calculation of the 1.5 percent operating reserve. In total, a majority of the Commission approved revenue increase for NBC of $2,348,622 or $309,387 less than the Division's surrebuttal position.[30] On June 30, 2006, NBC made a compliance filing to have new rates for effect July 1, 2006. On July 11, 2006, the Division recommended approval of the compliance filing. On July 13, 2006, the Commission approved NBC's compliance filing for effect July 1, 2006.

COMMISSION FINDINGS

I. INTRODUCTION

In general, the Division's surrebuttal position appears reasonable.[31] However, there were two specific areas the Commission determined needed an adjustment in order to create just and reasonable rates in the public interest. These two areas were health care expenses and the operating reserve. When setting rates, the Commission reviews the evidence and when necessary explores issues on its own initiative. As the parties in any rate proceeding are well aware, the Commission can reject the expert opinion of witnesses and utilize its own expertise.[32] Justice Brennan once declared that a rate making agency like this Commission "is not intended to be a passive arbiter but the guardian of the public interest" and thus is "not a prisoner of the parties' submission" but

[30] The approved cost of service is incorporated as Appendix A to this Report and Order.
[31] NBC agreed to the Division's surrebuttal position even after the proposed Settlement was not approved by the Commission.
[32] See Wakefield Water Co. v. PUC 457 A.2d 251, 253 (R.I. 1983), and Valley Gas Co. v. Burke 446 A.2d 1024, 1033 (R.I. 1982).

must "make full use of the expert knowledge of Commissioners and staff".[33] This Commission has always conducted itself in accordance with this legal principal.[34]

II. HEALTH CARE CO-SHARING

Public utilities are required to manage their operating expenses, for the "efficient and economical management" of the utility.[35] Operating expenses can be disallowed if the utility's decision results in "inefficiency" or "unnecessary costs".[36] The Rhode Island Supreme Court has been ever more explicit by declaring that the Commission's role in regulating a utility "exceeds mere regulation" because "Section 39-1-1 vests the Commission with the power to regulate and *supervise* the conduct of the utility for purposes of controlling its efficiency and protecting the public against improper and unreasonable rates".[37]

A utility has an obligation to run an efficient operation. In addition, the utility has the burden of proof to demonstrate the rates it proposes and the expenses it incurs are reasonable.[38] Originally, NBC attempted to justify increasing its health care expenses by $455,429. Subsequently, NBC agreed to the Division's surrebuttal position of increasing NBC's health care expenses by $254,955. However, even the Division's witness noted

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[33] Baltimore Ohio Co. v. United States, 386 U.S. 359, 427-430 (1967) (J. Brennan, concurring).
[34] Since 2001, the Commission, a three member body, has had five different commissioners. Only one commissioner, the present Chairman, has consistently dissented from applying this pro-active principal towards NBC. Thus, the inference of bias regarding NBC can easily be directed in reverse. In regards to the Commission's two prior decisions mentioned in the dissent, the CSO Auditor/Overseer decision was upheld by the R.I. Supreme Court while the only decision made regarding NBC's new pension plan was simply to investigate its financial impact on ratepayers. Being pro-active in order to properly protect ratepayers demonstrates diligence, not animus.
[35] See e.g. Chicago & Grand T. Ry v. Wellman 143 U.S. 339, 345-346 (1892); Missouri ex. Rel. Southwestern Bell Tel. Co. v. Missouri Pub. Serv. Comm. 262 U.S. 276, 289 (1923) and Bluefield Water Works v. Pub. Ser. Com. 262 U.S. 679, 643 (1923).
[36] See e.g. Missouri ex. Rel. Southwestern Bell Tel Co. v. Missouri Pub. Serv. Commission 262 U.S. 276, 289 (1923); West Ohio Gas Co. v. PUC 294 U.S. 63, 72 (1935) and Acker v. United States 298 U.S. 426, 430-431 (1936).
[37] Prov. Water Supply Bd. V. Malachowski 624 A.2d 305, 309 (R.I. 1993).
[38] See R.I.G.L. 39-3-12.

that "NBC should be instituting measures to control those costs" and mentioned employee co-sharing of premiums as one example of a cost control. The Division also noted that only new employees hired after June 30, 2004 are required to make any contributions toward medical insurance premiums. These contributions total only 0.3 percent of total medical insurance premiums for the rate year.[39] In fact, the total health care premium paid by employee co-share for the rate year was $8,727.[40] This in not in the public interest.

In a recent docket, the Commission declared that "NBC has provided little or no evidence that it is being pro-active in limiting personnel expenses." The Commission specifically stated that it "expects that in future rate cases involving personnel expenses, NBC would require its employees to share in the expense of their health care premiums".[41] In addition, in a prior docket, the Division's witness had indicated that it would be reasonable for non-union employees to have a 10 percent co-share for their health care premiums.[42] It appears NBC did not take the Commission seriously.[43] Only after an open meeting decision where the Commission proposed modifying the proposed Settlement to reflect the equivalent of a 10 percent co-share of health care premiums, did NBC indicate in a letter filed on June 5, 2006 that it had reached a tentative agreement with its unions for a co-sharing of health care premiums.

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[39] Div. Ex. 2, pp. 5-7.
[40] Div. Ex. 1, p. 12.
[41] Order No. 18124, p. 11.
[42] Id., p. 8.
[43] According to the NBC's Minutes of its Personnel Committee, in April 12, 2006, Mr. Pinault, NBC's Executive Director, "stated that NBC will be meeting with the unions today to kick off negotiations on the contract re-opener for health care." Ironically, this "kick off" for negotiations occurred two days after the hearing at the Commission at which NBC's witness admitted that more employees are requiring their employees to pay for a portion of their health care. Tr. 4/10/06, pp. 19-20.

NBC calculated that the savings from co-sharing in the rate year would be $70,116. It is clear that this does not represent a 10 percent co-share although NBC's witness testified that a co-share is becoming more common even in the public sector. In any case, NBC's proposed co-sharing is a step in the appropriate direction to manage personnel costs and have a more efficient operation.

Furthermore, NBC is not the only utility for which this Commission has reduced its cost of service in an attempt to reduce health care costs. Recently, the Commission disallowed $53,399 in health care benefits for the Kent County Water Authority ("KCWA") Board. Furthermore, the Commission required KCWA in its next rate case to undertake a review of its medical benefits and costs. In addition, the Commission noted that the policy of "reducing health care costs is becoming more prevalent throughout the public sector" and stated that KCWA "should take heed" of the Commission's expectation that employee co-sharing of health care premiums will occur.[44] The Commission is concerned that non-investor owned utilities are not running as efficiently as possible. Controlling personnel costs in general and health care costs specifically is a priority of the Commission to ensure that utilities are efficient and utility rates are just and reasonable. Accordingly, the Commission reduced NBC's cost of service by $70,116 to reflect the likely employee co-share of health care premiums.

III. OPERATING RESERVE

A non-investor owned utility's rates are set based on projected expenses for the rate year. To assist a non-investor owned utility with uncontrollable and unanticipated expenses or fluctuations in revenue, the Commission has granted an operating reserve to

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[44] Order No. 18316, pp. 25-27.

a utility.[45] However, the level of the operating reserve and whether to grant one are solely matters of discretion for the Commission. Thus, it is clear that "NBC is not entitled to an operating reserve and that the Commission can establish the funding level of such a reserve."[46] In the current filing, NBC calculated its operating reserve by applying the 1 ½% rate to its projected total rate year expenses ($63,574,563) less amounts provided for debt service ($25,872,877) and debt service coverage ($6,656,397). This amounted to a requested operating reserve of $458,934.

NBC's witness has indicated that he had "no objection to whatever percentage this Commission decides is an appropriate percentage" for setting the operating reserve and agreed NBC is not entitled to an operating reserve.[47] He further agreed that an operating reserve is a discretionary decision by the Commission.[48]

In fact, the Commission in the recent past has adjusted and reduced NBC's operating reserve. For instance, the Commission reduced NBC's operating reserve by $132,216 to $252,685. This was done in order to avoid giving NBC excessive funds with which to increase personnel costs.[49] Also, the Commission reduced NBC's operating reserve by $150,000 in order to allow the Commission to use these funds to finance an auditor/overseer of the CSO Project. Although NBC challenged this Commission's authority to reduce its operating reserve, the Rhode Island Supreme Court found NBC's argument "wholly without merit".[50]

[45] Order No. 17588, p. 31.
[46] Id.
[47] Tr. 4/10/06, p. 32.
[48] Tr. 6/19/06, p. 75.
[49] Order No. 17588, pp. 31-32 , and Appendix A.
[50] In Re: NBC Rate Filing 808 A.2d 631, 637 (R.I. 2002).

In setting an operating reserve, the Commission reviews a number of factors. Since these factors vary and are weighed differently, the operating reserve of utilities may differ and the level of an operating reserve may change from time to time for the same utility. The Commission will discuss some of the factors that were considered in setting NBC's operating reserve in this docket.

First, an operating reserve can be helpful if a utility experiences significant revenue fluctuations. For instance, some non-investor owned water utilities experience large revenue fluctuations due to changing weather patterns and a corresponding decline in water consumption.[51] This does not appear to be a major concern for NBC. NBC did not present evidence of widely varying revenue fluctuations. Furthermore, the Division's witness concurred that NBC derives a lower percentage of its revenue from consumption than other water utilities.[52] Thus, NBC has less of a need for an operating reserve than other non-investor owned water utilities.[53]

Second, an operating reserve can be helpful in addressing unanticipated increases in fuel costs especially in a time when energy costs are rising rapidly. For instance, in the past, the Commission recognized that rising energy costs for NBC could justify the need of a higher operating reserve.[54] However, in this docket, NBC has indicated that it has locked into long-term contracts for gas supply rates as well as electric rates including a

[51] See e.g. Order Nos. 18598 (Pawtucket Water), 19580 (Newport Water), and 18307 (Woonsocket Water).
[52] Tr. 4/10/06, pp. 30-31.
[53] In addition, it should be noted that revenue fluctuations due to consumption influenced by weather can also cause greater than expected revenues. However, there is usually no requirement that utilities make refunds to ratepayers for higher than anticipated revenues. Accordingly, utilities, in particular NBC, should be able to better manage these revenue fluctuations by engaging in cost cutting when revenues are lower than expected or by creating reserves when revenues are higher than anticipated so they can be used when revenues are low. Private sector utilities are capable of this type of budgeting and it is unclear why non-investor utilities such as NBC can not do so as well.
[54] Order No. 18124, p. 9.

cap on electric usage at Bucklin Point.[55] Although NBC should be complimented for being pro-active in sheltering itself from volatile energy costs, under these circumstances, there appears to be less of a need for NBC to have an operating reserve to address large potential increases in energy costs.

Third, an operating reserve can be useful in addressing "unexpected increases in expenses, which are truly beyond the control of the utility."[56] Personnel costs are not uncontrollable by a utility. As noted previously by the Commission, "personnel costs, in contrast, can be controlled by an employer through co-sharing of premiums, salary freezes or lay-offs."[57] This is particularly applicable to NBC since it is a utility managed by an independent board, with significant control over its personnel costs. The Commission has indicated that "NBC has many options in relation to its personnel costs".[58] NBC, like KCWA, can manage its personnel costs directly. It is not a non-investor owned utility who is managed by, controlled by or considered a part of a municipality.[59] Since NBC can control the increase in its personnel costs, especially for its non-union employees, which compose approximately half of its workforce, there is little need for NBC to have an operating reserve to address personnel costs. In fact, a large operating reserve may allow a utility to be less efficient and more lax with personnel costs. The Commission has indicated that "performance based ratemaking ("PBR") has successfully kept distribution rates at stable levels in the energy sector" and stated that "a similar approach to non-investor utilities to limit their personnel costs"

[55] NBC Ex. 1, p. 5; NBC Ex. 2, p. 3; and Div. 3, pp. 7-9.
[56] Order No. 18316, p. 27.
[57] Id.
[58] Order No. 17558, p. 32.
[59] NBC is non-investor owned utility managed by an independent board. It has significant discretion to manage its personnel costs. Similarly, KCWA is a utility with independent discretion to manage personnel costs.

should be considered.[60] Exclusion of personnel costs from the calculation of an operating reserve will incent NBC to manage it personnel costs. This approach will likely be applied for other similarly situated utilities.

Fourth, an operating reserve can be in the public interest if the utility treats the funds received from the Commission as an operating reserve to be used when it is necessary to meet expenses approved in the utility's cost of service. NBC has indicated that it budgets more than this Commission allocates in rates. In addition, NBC acknowledged that the operating reserve approved by the Commission "is not included as a separate line item in the budget."[61] Thus, NBC appears not to treat the operating reserve as a reserve but as merely more money to spend for its own Board approved budget despite the fact that it exceeds what the Commission approves in rates. Thus, NBC's management is not treating the operating reserve as a "rainy day fund" or using it for "cash flow" but as additional revenues to pay for expenses not necessarily approved by the Commission. Accordingly, the Commission will not approve a large operating reserve since there are no assurances it will only be used for necessary and unanticipated expenses.

NBC has attempted to indicate that it needs a larger operating reserve since it will face higher expenses than anticipated in areas such as $70,000 more for workers' compensation or $60,000 more for the PUC assessment. However, NBC certainly could have filed for a larger rate increase or used a test year with the correct amount of the PUC assessment.[62] Also, the Division has not had the opportunity to review the veracity of these "unanticipated" expenses. Furthermore, even NBC's witness acknowledged that in

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[60] Order No. 18124, p. 12.
[61] Tr. 6/19/06; pp. 76-77, and NBC Rec. Resp. 3 (6/21/06).
[62] Tr. 6/19/06, pp. 55-56, 69-71.

budgeting, the "bad news" is found out before the "good news" and there may be savings throughout the year; in fact, he expected "there will be savings." In addition, NBC's witness acknowledged that NBC would not file for a rate increase for an amount equal to the proposed operating reserve of $458,000, but would instead "figure out a way to offset" increased expenses with cost savings elsewhere.[63] If NBC can not somehow find cost savings, it can always file a rate case. In any event, a large operating reserve for NBC is unnecessary and in the past NBC has admitted it could avoid "unnecessary risk" with a reserve of $250,000.[64] In this case, the Commission is setting the operating reserve at $219,663 by exclusion of personnel costs from the calculation of the operating reserve.

Over time, the Commission has eliminated all debt service/capital costs from the operating reserve calculation for several non-investor utilities.[65] To bring more accountability and incent utilities to manage personnel costs, personnel costs should likewise be excluded from the operating reserve calculation because a utility such as NBC can control these costs. Certainly, similarly structured utilities where the management can control personnel expenses, such as KCWA, will be subject to the same rigorous scrutiny. Although a smaller operating reserve may be more challenging to NBC, a challenge for this Commission is to protect ratepayers from unnecessarily high utility rates caused by a larger than justified operating reserve.

IV. CSO OVERSEER FUNDS

Lastly, in 2001, the Commission established a restricted account to fund a CSO Auditor/Overseer. An annual amount of $150,000 is placed into this account. At this

[63] Id., pp. 69-71
[64] Order No. 17588, p. 31.
[65] Tr. 6/19/06, p. 58.

time, there is approximately $800,000 in this account. Since the CSO project Phase I is nearing completion, there is less need for funds in this account. Accordingly, at this time the Commission is limiting the amount in this account to $150,000. This will not reduce NBC's rates since the funds allocated to the CSO Auditor/Overseer account are used for coverage of debt service. This change will merely give NBC additional flexibility in meeting its debt service requirements and the funds remain restricted for debt service and other capital needs.

(18719) <u>ORDERED;</u>

1. Narragansett Bay Commission's abbreviated rate application of November 1, 2005, is hereby denied and dismissed.

2. A revenue requirement increase of $2,348,622 resulting in a cost of service of $63,284,139 is hereby approved for effect July 1, 2006.

3. The Commission will continue to restrict the Debt Service, Debt Service Coverage, and CSO Oversight funds. The debt service accounts will continue at amounts previously approved in Docket 3639, Report and Order No. 18125: Debts Service--$25,872,877; Debt Service Coverage--$6,656,397. The Commission Oversight funds for the Combined Sewer Overflow project are now reduced to the level of $150,000. Additionally, Debt Service Coverage funding may be used for payment of Capital Improvement Program projects and for capital outlays. The restricted funds shall only be used for their designated purposes and excess/available funds shall be invested in an interest bearing account.

4. Narragansett Bay Commission shall comply with all other findings and instructions in the Report and Order.

EFFECTIVE AT WARWICK, RHODE ISLAND, PURSUANT TO AN OPEN MEETING DECISION ON JUNE 22, 2006 AND JULY 13, 2006. WRITTEN ORDER ISSUED SEPTEMBER 14, 2006.

PUBLIC UTILITIES COMMISSION

Elia Germani, Chairman*

Robert B. Holbrook, Commissioner

Mary E. Bray, Commissioner

*Chairman Elia Germani dissented from Sections III & IV of the Commission findings. His dissent is attached.

NOTICE OF RIGHT OF APPEAL PURSUANT TO R.I.G.L. SECTION 39-5-1, ANY PERSON AGGRIEVED BY A DECISION OR ORDER OF THE COMMISSION MAY, WITHING SEVEN DAYS (7) DAYS FROM THE DATE OF THE ORDER, PETITION THE SUPREME COURT FOR A WRIT OF CERTIORARI TO REVIEW THE LEGALITY AND REASONABLENESS OF THE DECISION OR ORDER.

Appendix A

Narragansett Bay Commission
Docket 3707
Cost of Service

	Division Surrebuttal Position *	Commission Adjustments	Proforma
REVENUES			
User Fee Revenues	$ 60,470,708	$ (309,387)	$ 60,161,321
Other Service Revenues	2,382,618		2,382,618
Miscellaneous	740,200	-	740,200
Total Revenues	$ 63,593,526	$ (309,387)	$ 63,284,139
EXPENSES			
Personnel Services	$ 15,951,367	$ (70,116)	$ 15,881,251
Operating Supplies &Exp	12,307,595		12,307,595
Special Services	2,336,666		2,336,666
Capital Outlays	1,892,350		1,892,350
Prior Year Debt Coverage	(1,892,350)		(1,892,350)
Amortization	9,690		9,690
Debt Service	25,872,877		25,872,877
Debt Coverage	6,656,397	-	6,656,397
Total Expenses	$ 63,134,592	$ (70,116)	$ 63,064,476
OPERATING RESERVE	458,934	(239,271)	219,663
COST OF SERVICE	$ 63,593,526	$ (309,387)	$ 63,284,139
RATE YEAR REVENUES AT PRESENT RATES	60,935,517		60,935,517
REVENUE INCREASE	$ 2,658,009	$ (309,387)	$ 2,348,622

* NBC agreed with the surrebuttal cost of service filed by the Division.

DISSENTING OPINION OF ELIA GERMANI

In my six years as chairman of the Public Utilities Commission, all but one of the non-investor owned utilities has suffered either from mismanagement or operational problems. The only non-investor owned utility that has had no such problems is the Narragansett Bay Commission (NBC) which is the shining star in a rather dull firmament. It has been nationally recognized as one of the best wastewater facilities in the country both in term of its operational excellence but also for its financial management and high level executive performance. Despite this fact, the Commission in three split decisions has acted in a manner which has been adversarial to NBC and not in the objective manner one would expect from a quasi-judicial agency.

The first example of this adversarial attitude was in an order of the Commission creating the so-called "Special Master". That split decision was based not on any evidence in the record but was politically inspired and motivated. The decision was primarily made to advance the career of the then Attorney General. My dissenting opinion in that case clearly details the imperfections of the majority decision. That decision cast negative aspersions on the Combined Sewer Overflow (CSO) project which were unjustified. Finally, after several years, at my insistence, the account which had accumulated almost $1 million for the Special Master has been terminated.

The second example of an adversarial attitude by the majority was the furor surrounding the Defined Benefit Plan (DBP) which had been proposed for the management of NBC. NBC is unlike most other companies in that the union pension plan is far superior than the pension plan for management. The union plan by statute offered a pension of 80% of the average of the salary for the three highest years after 35 years of service. The NBC proposal which was subjected to extraordinary scrutiny by the Commission was a partial allocation of funds from a defined contribution plan to a defined pension plan. That pension plan which required no additional funds provided for a maximum pension of 30% of the average of the salary for the three highest years after 30 years of service. The majority authorized and engaged the services of a nationally recognized pension benefit consulting firm to scrutinize the proposed pension plan. Not only that, the majority in that case accused the management and directors of NBC of not acting in the best interest of ratepayers. It was clear that the majority manifested hostility toward NBC, its management and its board of commissioners.

In this proceeding, the majority has reduced the operating reserve for NBC. The order is based is not based on the recommendation of the Division, which has performed in an exemplary manner in advocating the interests of ratepayers, but by the Commission on its own. That was also true of the pension investigation and the creation of the special master in which the Division, as ratepayer advocate, did not support the Commission's decision. Clearly, in all three instances the Commission has not acted as a quasi-judicial agency but more like an adversary. While I recognized that the operating reserve is a matter of discretion by the Commission, that discretion should be exercised in an even-handed manner. Support for the majority position is testimony which was elicited by NBC's accounting expert in questions by the Commission Counsel. No other non-investor owned utilities has had its operating reserve reduced in a similar manner.

It may well be that the majority believe that NBC needs a limited operating reserve because it operates in an efficient manner. We all know an operating reserve is permitted because no investor owned utility's only source of revenue is ratepayer funds. There is no equity investment which provides for funds when expenses exceed revenues. It also provides a cushion since all rate determinations are based upon projection of revenues and expenses which may not always be completely accurate. While I am reluctant to dissent in rate proceedings because I prefer that the Commission act unanimously on important matters, I think the actions of the majority in this instance require my dissent since I think it was based on animus not evidence. For these reasons, I respectfully dissent.

Elia Germani, Chairman

September 14, 2006