NEW ENGLAND GAS COMPANY

DISTRIBUTION ADJUSTMENT CLAUSE FILING

RIPUC DOCKET NO. 3760

BEFORE THE
RHODE ISLAND PUBLIC UTILITIES COMMISSION

TESTIMONY AND EXHIBITS
OF DAVID J. EFFRON

ON BEHALF OF THE

DIVISION OF
PUBLIC UTILITIES AND CARRIERS

OCTOBER 13, 2006

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DIRECT TESTIMONY
OF DAVID J. EFFRON

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 12 Pond Path, North Hampton, New Hampshire, 03862.

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, 2006, National Grid ("the Company") filed the Earnings Sharing calculation for New England Gas Company ("NEG") for Fiscal Year 2006. This Earnings Sharing Calculation was filed pursuant to the Commission's approval of the incentive based Earnings Sharing Mechanism ("ESM") contained in the Settlement Agreement in Docket 3401 ("Settlement"). National Grid acquired the assets of NEG on August 24, 2006. The results for Fiscal Year 2006 reflect operations prior to the acquisition of the NEG assets by National Grid.

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. The Company calculated excess revenue of zero to be credited to the DAC. Based on my review and analysis of information provided by the Company, I am not proposing to modify the zero credit calculated by the Company.

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, 2006. 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 return on common equity earned by NEG for the twelve months ended June 30, 2006 (“FY2006”)?

A. Yes. The Company calculated that NEG earned a return on common equity of 4.34% in FY2006, resulting in a zero credit to customers for earnings sharing (Attachment SP1, accompanying the testimony of Ms. Partridge).

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 SP-1 to the direct testimony of Ms. Partridge. My examination included an analysis of the Company's financial statements for the twelve months ended June 30, 2006, workpapers supporting the return on equity calculation, and responses to requests for information.

Q. Based on your examination, should the Company's calculation of zero credit to customers for earnings sharing in FY2006 be modified?

A. No. While certain modifications to the Company's calculation of the earned return on equity might be appropriate, in order to get the earned return into the sharing range, the pre-tax income calculated by the Company would have to be increased by approximately $11.6 million. I have not identified potential adjustments that would, in sum, approach this magnitude.

Q. The return on equity of 4.34% is a significant decrease from the return reported in Fiscal Year 2005. To what do you attribute this decrease?

A. The margin (revenues less the cost of gas) decreased somewhat from FY2005, and the rate base increased somewhat from FY2005. However, the main reason for the decrease in the earned return on equity was a substantial increase in operation and maintenance expense. I have prepared a comparison of the components of the earned return on equity in Fiscal Years 2005 and 2006 on my Schedule DJE-1

Q. Please describe your Schedule DJE-1.

A. I have begun in the first column with the return on common equity in FY2006 as calculated by the Company on Attachment SP-1, Pages 1 and 2. In the next column, I show the return on common equity in FY2005 as calculated by the Company in its compliance filing in Docket No 3690. The third column is the difference between the two years. As can be seen in this comparison, the decrease in the earned return on equity is due mainly to the increase in operation and maintenance expense.

Q. Have you analyzed the increase in operation and maintenance expense from FY2005 to FY2006?

A. Yes. The largest increases in operation and maintenance expense were in the areas of distribution maintenance - $1.9 million and customer accounts - $5.6 million.

Q. Has the Company explained these increases?

A. Yes. The Company explained that the increase in distribution maintenance is the result of an increase in security services and a change in the method of allocating supervisory labor time.

The increase in customer accounts expense is due mainly to the cost of increased collection efforts and an increase in uncollectible accounts expense. The increase in uncollectible accounts expense, $3.8 million, is the largest single expense increase from FY2005 to FY2006. While the increase in uncollectible accounts can be attributed in part to the higher revenues associated with higher gas costs, this alone does not explain the magnitude of the increase in uncollectible accounts. Further, the increase in collection efforts described by the Company should logically be expected to mitigate the increase in uncollectible accounts from year to year.

Q. In your opinion, has the Company adequately explained the increases in operation maintenance expense from FY2005 to FY2006?

A. No. For example, the Company has offered the change in the method of allocating supervisory labor time as an explanation for increases in several expense accounts. While such a change in method of allocation can result in increases in individual expense accounts, it should not result in any change to the overall level of expense. With regard to the customer accounts expenses, the Company has not adequately explained the magnitude of the increase in uncollectible accounts in FY2006 or why this expense has increased despite the additional collection efforts.

Q. Why are you not then proposing any adjustments to these expenses for the purpose of the ESM calculation?

A. Even if I were to recommend that the operation and maintenance expense reflected in the FY2006 ESM calculation be frozen at the FY2005 level, the calculated return on equity would still not exceed the 11.25% threshold. Therefore, there would be little purpose to recommending such adjustments. However, in Docket No. D-06-13 before the Rhode Island Division of Public

Utilities and Carriers, the Company committed to filing a new rate plan within a year after the closing of the acquisition of the NEG assets. The increased level of expenses should be investigated and addressed in the course of the review of the new rate plan to be filed by the Company.

Q. Does this conclude your direct testimony?

A. Yes.

Schedule DJE-1

NEW ENGLAND GAS COMPANY
COMPARISON OF RESULTS OF OPERATIONS
FISCAL YEARS ENDED JUNE 30, 2006 AND JUNE 30, 2005
($000)

	(1) FY2006	(2) FY2005	Difference
Revenue	$ 459,740	$ 410,617	$ 49,123
Cost of Gas	312,661	261,341	51,320
Margin	147,079	149,276	(2,197)
O&M Expense Excluding Purchased Gas	85,476	76,971	8,505
Depreciation and Amortization	22,238	20,753	1,485
Other Taxes	21,203	22,243	(1,040)
Income Taxes	2,821	7,000	(4,179)
Operating Expenses Excluding Purchased Gas	131,738	126,967	4,771
Operating Income	15,341	22,308	(6,967)
Interest on Short-Term Debt	1,047	674	373
Interest on Long-Term Debt	8,980	8,724	256
Other Interest	134	118	16
AFUDC	(59)	(207)	148
Total Interest Expense	10,102	9,308	794
Net Income	5,239	13,000	(7,761)
Preferred Dividends	475	461	14
Net Income for Common Equity	$ 4,764	$ 12,539	$ (7,775)
Common Equity	$ 109,695	$ 106,568	$ 3,127
Return on Common Equity	4.34%	11.77%	-7.42%

Sources:
(1) Attachment SP-1, Pages 1 and 2
(2) SP-3 Compliance Filing, Docket No. 3690