STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: NATIONAL GRID'S DISTRIBUTION ADJUSTMENT CLAUSE : DOCKET NO. 3760

REPORT AND ORDER

I. NEGAS' AUGUST 1, 2006 FILING

On August 1, 2006, the New England Gas Company ("NEGas"), a division of Southern Union, filed with the Rhode Island Public Utilities Commission ("Commission") its annual Distribution Adjustment Clause ("DAC") for effect November 1, 2006. The DAC is filed annually to establish a factor that returns or recovers funds from ratepayers over the twelve-month period starting November 1st. The DAC provides for funding, or the reconciliation and refund of amounts associated with specific programs. The DAC filing results in a factor that is applied to firm sales and firm transportation customers.

The actual DAC factor results from nine components, which are filed with a specific factor that is incorporated into the overall DAC factor. The component factors are: (1) a System Pressure factor, in which 20.39 percent of LNG commodity costs, financing costs, and supplier demand costs are allocated and used to maintain system pressures in the NEGas' distribution system; (2) a Demand Side Management ("DSM") factor, which has $300,000 annually in the base distribution rates, and therefore the DSM factor is zero unless Commission changes the amount for DSM funding; (3) a Low Income Assistance Program factor ("LIAP"), which has $1,785,000 annually in the base distribution rates, $1,585,000 in supplements to the Federal Low Income Heating Energy Assistance Program ("LIHEAP") and $200,000 for a Low Income Weatherization

Program, and therefore the LIAP factor is zero unless Commission changes the amount for LIAP funding; (4) an Environmental Response Cost ("ERC") factor, which has $1,310,000 annually in base distribution rates, but annual adjustments for incremental environmental costs or credits such as insurance recoveries are amortized over a 10-year period through this factor; (5) an On-System Margin Credit factor, which provides for the sharing of non-firm sales and transportation margins, whereby ratepayers receive 75 percent of non-firm margins over $1.6 million, and NEGas retains the remaining 25 percent of margins; (6) a Weather Normalization factor, which represents an adjustment to NEGas revenues to account for the impact of weather that varies by more than 2 percent from normal degree days during the preceding winter period of November through April; (7) an Earning Sharing Mechanism factor ("ESM"), which provides for the sharing and refunding of NEGas' earnings, whereby ratepayers receive 50 percent of earnings between an 11.25 percent and 12.25 percent return on equity("ROE"), and ratepayers receive 75 percent of earnings over 12.25 percent ROE while NEGas retains the remaining share of earnings; (8) a reconciliation factor for the current DAC, which represents a true-up of the amount currently being collected for the DAC component factors approved by the Commission for the prior period; and (9) a Service Quality Plan Penalty, which is for any penalty assessed to NEGas' service quality as measured through the Service Quality Plan approved by the Commission in Docket 3476.

In support of its filing, NEGas submitted pre-filed testimony by Peter Czekanski, Director of Pricing for NEGas. Mr. Czekanski's testimony described the DAC and the changes to the various components of the DAC. He presented factors for all components except for the ESM factor.

As for the System Pressure factor, NEGas proposed an increase in the factor to $0.0059 per therm. The factor is based on the commodity related portion of LNG costs projected from November 2006 through October 2007. In regards to DSM, Mr. Czekanski explained that the DSM program was established in Docket No. 2025 to promote the development of energy-efficient natural gas technologies that increase utilization of natural gas during periods of low demand. He noted that increased off-peak usage reduces the unit cost of gas for all customers by generating distribution revenues to support fixed costs associated with resources needed during peak periods. He explained that a complete review of the DSM program will be undertaken as part of the merger with National Grid and a result of recently state enacted legislation. NEGas proposed no change to the existing level of funding in the base rate, which is $300,000 annually. He noted that NEGas has $346,655 available from fiscal year 2006. There are three approved projects with rebates totaling $305,267 awaiting full implementation, and a balance of $41,388 not designated for specific projects. Thus, the sum of the non-designated carry over balance, plus $300,000 equates to $341,388 available for fiscal year 2007. For LIAP, Mr. Czekanski stated that this factor provides additional funding to LIHEAP and to a low income weatherization program. He noted that annual funding in distribution rates for LIHEAP and weatherization are $1,585,000 and $200,000, respectively. There is also $17,400 being carried over from fiscal year 2006. NEGas proposed no change to the current level.[1]

In relation to the ERC factor, NEGas proposed a decrease in the factor to ($0.0019) per therm. This factor reflects a 10 year amortization of environmental response costs. The proposed ERC factor reflects annual amortization of expenses

[1] NGrid Ex 1: (Czekanski's direct testimony), pp. 3-8

totaling $659,735. Since there is $1,300,000 of ERC funding embedded in base rates, there will be a net refund to ratepayers of $650,265. In the area of on-system (non-firm) margins, NEGas proposed a credit factor of ($0.0041) per therm. Mr. Czekanski calculated that NEGas recorded $3,496,294 of non-firm margins or $1,896,294 more than the $1.6 million threshold, which results in 75%, or $1,422,220, to be credited to customers and 25%, or $474,073 to be retained by shareholders. As to weather normalization, NEGas proposed a factor of $0.0027 per therm. Mr. Czekanski noted that during the winter period of November 2005 through April 2006, the weather was warmer than normal and there were 103 degree days in excess of the threshold. As a result, $927,000 will be charged to customers.[2]

Mr. Czekanski explained that the earning sharing calculation had not been completed because NEGas' financial data for the fiscal year ending June 30, 2006 had not been completed, but NEGas will supplement this filing and provide the calculation no later than September 1, 2006. This filing will include the adjustments made at the May 2006 open meeting by the Commission to NEGas' earning sharing calculation for fiscal year 2005. Also, Mr. Czekanski stated that NEGas incurred no service quality penalties for fiscal year 2006. As for the reconciliation factor for fiscal year 2005, NEGas proposed a credit factor of ($0.0008) per therm. The total overcollection was $292,354, which was primarily due to the winter being warmer than normal thereby resulting in lower than projected LNG costs as well as reducing total through-put, which resulted in customers receiving a smaller credit than appropriate.[3]

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[2] Id. pp. 8-11.
[3] Id. pp. 11-16.

II. NGRID'S SEPTEMBER 1, 2006 FILING

On September 1, 2006, National Grid ("NGrid")[4] submitted the direct testimony of Sharon Partridge, Vice President of Special Projects, Finance for NGrid, and the supplemental testimony of Peter Czekanski. Ms. Partridge provided the calculation of NEGas' earnings under the ESM factor. She determined that for the fiscal year ending June 30, 2006, the ROE was 4.34 percent, and ratepayers were not entitled to receive a credit because the earnings did not exceed the 11.25% ROE threshold. The primary reasons for the decrease in earnings were a combination of warmer weather and decreased usage per customer. Ms. Partridge stated that fiscal year 2006 was 9.4% warmer than the prior year, which coupled with customer conservation, resulted in a decrease in base revenues from firm sales customers of approximately $5.8 million.

NEGas determined that its net income available for common equity for the fiscal year ending June 30, 2006 was $4,763,627. This was based on various adjustments to NEGas' operating revenues and expenses. First, fiscal year 2006 had a warmer than normal winter resulting in $927,000 to be recovered from ratepayers through the Weather Normalization Clause. As a result, the operating income for purposes of the ESM was increased by $927,000. Second, NEGas' portion of non-firm margins were excluded from fiscal year 2006, or $474,073 from the ESM. Third, NEGas and the Division agreed to remove stored gas inventory from rate base and to eliminate carrying costs on stored gas inventory from revenues, which decreased operating revenues by $3,130,242. Fourth, NEGas excluded unbilled revenues from the ESM, decreasing operating revenues by $1,198,651. Fifth, NEGas excluded the effect of fiscal year 2005 ESM over-earnings of

[4] On August 24, 2006, Narragansett Electric Company, doing business as National Grid, acquired the assets and gas business of Southern Union Company in Rhode Island, doing business as NEGas.

$423,222. Sixth, NEGas included the investors' share of annual net merger savings, or $2,049,000 in operating expenses. Seventh, NEGas excluded a portion of NEGas' incentive compensation, which decreased operating expenses by $255,098 and excluded all expenses related to corporate level incentive compensation. Eighth, NEGas excluded all lobbying expenses from the ESM. Ninth, NEGas booked all expenses relating to the Tidewater mercury-release incident below the line, thereby excluding these costs for purposes of the ESM calculation. Tenth, NEGas excluded 50 percent of advertising and public relations expenses, which decreased operating expenses $68,956. Eleventh, NEGas amortized the cost related to a Health, Safety and Environmental Study over a three-year period, which increased operating expenses for fiscal year 2006 by $191,500. Twelfth, for other interest expense, NEGas included only those costs associated with customer deposits. Thirteenth, NEGas removed from operating expenses the net incentive related to the Gas Purchase Incentive Plan and recorded $127,201 below the line. Lastly, NEGas excluded amounts relating to Contributions in Aid of Construction ("CIAC") from rate base. [5]

Regarding the calculation of accumulated deferred income taxes ("ADIT"), NEGas worked to separate deferred income taxes related to accelerated depreciation and excluded amounts booked pursuant to FAS 109 for the Rhode Island portion of NEGas. Thus, NEGas rolled forward the ADIT balance related to depreciation less FAS 109 from the time of the merger through June 30, 2006. The roll-forward calculation includes the actual ADIT for the six months ending December 31, 2005 and an estimate for the six months ending June 30, 2006. In addition, for the ESM, NEGas utilized the statutory tax rate of 35 percent for calculating NEGas' federal income taxes. Ms. Partridge utilized an

[5] NGrid's Ex. 3 (Partridge's direct testimony), pp. 2-9.

imputed capital structure of: 43.6 percent common equity, 1.9 percent preferred stock, 45.7 percent long-term debt, and 8.8 percent short-term debt. She also utilized the following cost of capital rates: 11.25 percent for common equity, 9.93 percent for preferred stock, 7.81 percent for long-term debt, and 4.73 percent for short-term debt, which is based on the recent 12 month average cost of short-term debt for Southern Union. Also, NEGas included funds associated with the allowance for funds used during construction in calculating operating income.[6]

In calculating the rate base, NEGas used a five-quarter average ending June 30, 2006. However, Ms. Partridge excluded environmental response costs and prepaid taxes from rate base. She did include construction work in progress in the rate base and computed the working capital allowance pursuant to the method approved in Docket No. 2286. Also, the deferred debits in the rate base included Y2K costs, amortized at the rate of $240,000 per year, and excluded the costs associated with the Legacy customer-information systems. She calculated that earnings were below 11.25 percent ROE. As a result, Ms. Partridge indicated that no amount would be returned to ratepayers. As for the ESM calculation for fiscal year 2005, Ms. Partridge calculated an additional $310,942 in earning sharing as a result of the open meeting of May 11, 2006.[7]

Mr. Czekanski updated the proposed DAC. He updated the LNG commodity costs by reducing them from $2,054,894 to $1,857,787, for a revised System Pressure factor of $0.0054 per therm. Mr. Czekanski also updated the reconciliation component of the DAC for a revised reconciliation factor of ($0.0009) per therm. Also, he included in the DAC an additional $310,942 refund resulting from the Commission's adjustments to

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[6] Id. pp. 9-11.
[7] Id. pp. 11-13.

the fiscal year 2005 ESM calculation. Accordingly, there is a proposed DAC charge of $0.0003 per therm. The impact of the proposed DAC on a bill for a typical residential heating customer is an increase of two-tenths of a percent or $4 per year.[8]

III. DIVISION'S DIRECT TESTIMONY

On October 13, 2006, the Division of Public Utilities and Carriers ("Division") submitted the direct testimonies of Bruce Oliver and David Effron. Mr. Oliver discussed all elements of the DAC except the ESM. For the System Pressure factor, Mr. Oliver determined that NGrid's proposed factor filed on September 1, 2006 was mathematically accurate. Also, Mr. Oliver indicated that through informal discovery he determined that no LNG was used for economic dispatch this past winter. For the DSM factor, Mr. Oliver noted that $41,388 remains unexpended and uncommitted from fiscal year 2006. There is also $305,267 of funds committed to three already approved projects awaiting full implementation. In addition, Mr. Oliver noted that there is $300,000 of expected annual funding for DSM through base rates for fiscal year 2007. Mr. Oliver explained that interest is earned for ratepayers on the unexpended balance of DSM funds. Mr.Oliver recommended no change in the DSM factor. For the LIAP factor, Mr. Oliver stated that the LIAP funding is $1,785,000 per year, not including the working capital

[8] NGrid Ex. 2 (Czekanski's supplemental testimony) pp. 1-3. The components of the proposed DAC are shown as compared to the prior year's factors:

Description of Component	Current Factor per therm	Proposed Factor per therm
System Pressure	$0.0056	$0.0054
Demand Side Management	($0.0001)	-0-
Low Income Assistance	-0-	-0-
Environmental Response Cost	($0.0019)	($0.0019)
On-System Margins	($0.0033)	($0.0041)
Weather Normalization	($0.0045)	$0.0027
Earnings Sharing	($0.0003)	($0.0009)
Reconciliation Factor	$0.0014	($0.0009)
DAC FACTOR	($0.0031)	$0.0003

allowance, but $17,400 of LIHEAP funding will be carried over from fiscal year 2006 to fiscal year 2007. Mr. Oliver found no reason to question the level of LIAP funding.

Regarding the ERC factor, Mr. Oliver noted that NEGas is seeking approval of a net recovery of ($650,265). This negative amount reflects: a 10-year amortization of $12,510,252 of net ERC costs incurred through the end of fiscal year 2002; a 10-year amortization of ($6,012,673) of net ERC costs for fiscal year 2003; a 10-year amortization of ($472,960) of net ERC costs for fiscal year 2004; a 10-year amortization of $136,707 of net ERC rates for fiscal year 2005; a 10-year amortization of $436,020 of net ERC costs for fiscal year 2006; and a deduction of $1,310,000 for budgeted base rate recovery of ERC costs. As a result, the net balance of ERC at the end of the 2006 fiscal year was $3,477,968. He noted the proposed ERC credit factor ($0.0019) per therm represents no change in the ERC factor. He stated that for fiscal year 2006 NEGas claimed a net ERC cost of $436,028 of which 65% or $284,643 are costs associated with the removal and replacement of 59 Mercury Seal Regulators ("MSRs"). Mr. Oliver indicated that compared to past experience these costs appear high. For example, in prior periods 9,000 MSRs were replaced at $1,255,930 or $140 per MSR but the cost of removing these 59 MSRs equated to $284,643 or $4,824 per MSR. Mr. Oliver explained that approximately $150,000, a large portion of the total costs for the MSRs, was for the clean-up of one site. He also explained that most of the increase in the MSR removal costs was due to increases in NEGas' real time vapor screening and follow-up testing as well as the involvement of contractor personnel in the transport of the removed MSRs to a facility in Braintree, Massachusetts. In conclusion, Mr. Oliver found the environmental

response costs for fiscal year 2006 to be reasonable and the proposed ERC factor appropriately computed.[9]

In the area of on-system margin credits, Mr. Oliver noted the increase in non-firm gas sales was due to high fuel oil prices. He accepted NEGas' calculation, but stated he would continue to investigate the matter to determine the accuracy of NEGas figures. As for the Weather Normalization factor, Mr. Oliver found NEGas' proposed factor to be accurate. Also, Mr. Oliver found the proposed DAC reconciliation factor to be appropriate. Mr. Oliver recommended approval of the proposed DAC charge of $0.0003 per therm. In addition, he noted that the company lowered its forecasted firm gas use but did not re-compute each of its adjustment factors using the lowered gas use projections. However, he stated that the company's failure to re-compute all of the DAC factors will have no material impact. Also, he noted that the company should be required to use its actual short-term debt rates in reconciliation filings because NEGas' monthly short-term debt rates are lower in most months than the Bank of America Prime Rate currently used to compute interest on over or under recovery balances. Lastly, Mr. Oliver noted that the average weather normalized annual gas use per customer for 2006 was higher than what the company represents as usage for a typical customer. For instance, an average residential heating customer of NEGas used 1,164 therms in the year ending June 30, 2006, but NEGas computed a bill impact for a typical residential heating customer to be 1,035 therms. He encouraged the company to update its measure of a typical customer's usage and expand the ranges of gas use for which bill comparisons are computed.[10]

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[9] Div. Ex. 1 (Oliver's direct testimony), pp. 4-16.
[10] Id. pp. 12-18.

In his pre-filed testimony, Mr. David Effron discussed the ESM calculation. Mr. Effron recommended that the company's calculation of zero credit to ratepayers for earnings sharing in fiscal year 2006 should not be modified. Mr. Effron did not identify any potential adjustment which in total would increase NEGas' pre-tax income by approximately $11.6 million in order for NEGas' ROE to be above the 11.25% percent threshold. However, Mr. Effron noted that the main reason for the decrease in NEGas' ROE, to 4.34%, was due to a substantial increase in operation and maintenance expense. From fiscal year 2005 to fiscal year 2006, NEGas' distribution maintenance increased by $1.9 million, and customer accounts increased by $5.6 million. Mr. Effron indicated that NEGas stated that the increase in distribution maintenance was due to an increase in security services and a change in the method of allocating supervisory labor time, while the increase in customer accounts was due to the cost of increased collection efforts and an increase in uncollected accounts expense of $3.8 million. Mr. Effron did not find NEGas' explanation of these increases adequate. However, Mr. Effron noted that even if the operation and maintenance expense reflected in fiscal year 2006 was reduced to the fiscal year 2005 level, the ROE would not exceed 11.25%. In conclusion, Mr. Effron stated the increased level of expenses should be investigated and addressed when NGrid files it new rate plan, which will occur within a year of NGrid's acquisition of NEGas.[11]

IV. HEARING

Following published notice, a public hearing was conducted on October 25, 2006 at the Commission's offices at 89 Jefferson Boulevard, Warwick, Rhode Island. The following appearances were entered:

[11] Div. Ex. 2 (Effron's direct testimony), pp. 3-8.

FOR NGRID	:	Laura Olton, Esq.
FOR THE DIVISION	:	Paul Roberti, Esq. Assistant Attorney General
FOR THE COMMISSION:		Steven Frias, Esq. Executive Counsel

At the hearing, NGrid presented as its witnesses, Mr. Czekanski and Ms. Partridge. Under cross-examination, Mr. Czekanski agreed that the current DSM program is in reality a load growth for non-peak periods, and that the company is working on responding to the recent state legislation which requires a DSM program for natural gas utilities. Both Mr. Czekanski and Ms. Partridge testified that no costs associated with ERC or ESM in this filing are related to the mercury incident at the Tidewater site. Regarding the recent higher costs for MSR removal, Mr. Czekanski indicated that in the early stages of MSR removal there were different procedures under which the company was operating and in the past there were more MSRs to remove so there were some efficiencies that do not exist currently. As for the ESM, Ms. Partridge stated that base revenue from firm sales customers declined by $5.8 million from fiscal year 2005 to fiscal year 2006. Ms. Partridge also maintains costs increased in fiscal year 2006, because the company was catching up on Class 1 leaks. Also, Ms. Partridge stated that its uncollectible expense increased in fiscal year 2006 because of the combination of the aging of the receivables and the amount for the accounts written off. However, Ms. Partridge stated that in fiscal year 2006, the company was proactive in its collection policies and it terminated, in accordance with the Termination Rules, utility service this past winter, as it has done for the past several winters, and will continue to do so.[12]

[12] Tr. 10/25/06, pp. 8-9, 13-22.

Mr. Oliver testified on behalf of the Division. He indicated that he had not had an opportunity to review sufficient supporting detail for the company's determinations of non-firm margins, but would attempt to provide a more definitive response prior to the open meeting regarding his review of the company's data. Also, Mr. Oliver stated that he did not find anything unreasonable with the company's costs associated with MSR removal.[13]

On October 31, 2006, the Division filed a memorandum in response to a Commission record request indicating that the company has problems in tracking and reporting billing adjustments for non-firm customers that limits the Division's ability to verify the appropriateness of the company's reported non-firm margins. However, Mr. Oliver indicated that NGrid recognizes the problems in its current billing system and that the Commission should adopt the company's proposed non-firm margin factor and any adjustments could be reflected in future DAC proceedings.[14]

At an open meeting on October 31, 2006, the Commission reviewed the evidence and adopted a DAC factor of $0.0003 per therm. As for the non-firm margin sales, the Commission stated that the Division shall continue its review and that any adjustment in the DAC due to the Division's review will be implemented in the next DAC proceeding.

COMMISSION FINDINGS

The DAC is composed of various factors: System Pressure, ERC, DSM, LIAP, Weather Normalization, On-System Margins, reconciliation, and the ESM. In regards to the System Pressure factor, LNG commodity costs are projected to decrease to a level requiring $0.0054 per therm. The decrease in this factor is approved. Also, the

[13] Id., pp. 40-42.
[14] Div. Memo (10/31/06).

Commission approved an ERC credit factor of ($0.0019) per therm, which maintains the credit at its current level. In addition, NGrid proposed a Weather Normalization factor of $0.0027 to recover $927,000 reflecting the warmer than normal winter of 2005 to 2006. This factor is appropriately calculated. As for the Non-System Margin Credit factor, NGrid filed a credit of ($0.0041) per therm to return $1,422,220 to ratepayers. The Commission approved this factor. However, NGrid should rectify the problem in its billing system regarding non-firm margin sales. Any adjustment will be implemented in the next DAC filing. Regarding the reconciliation credit factor, NGrid proposed a factor of ($0.0009) per therm due largely to LNG commodity costs being lower than projected for fiscal year 2006 and a warmer than normal winter which reduced the total through-put. The over-collection should be returned and, therefore, the Commission approved this factor.[15]

As for the ESM factor, an additional credit for fiscal year 2005 of $310,942 is included. However, the ESM factor will not include any earnings to be returned to ratepayers for fiscal year 2006, because NEGas did not earn a ROE above 11.25% for fiscal year 2006. Accordingly, the Commission approved NGrid's proposed ESM credit factor of ($0.0009) per therm. The other components of the DAC, LIAP and DSM, remain essentially unchanged. As a result, the Commission adopted an overall DAC charge of $0.0003 per therm for effect November 1, 2006. The proposed DAC factor should recover approximately $104,000 from ratepayers over the twelve-month period starting November 1, 2006.

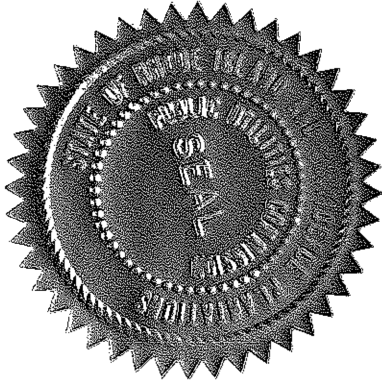
[15] These issues raised by the Division in regards to the short-term interest rates and bill impact analysis were also raised in Docket No. 3766 and will be discussed in greater detail in the order arising from that proceeding. For the moment, the Commission plans to fully address these issues when NGrid files in gas distribution rate plan in 2007.

Accordingly, it is

(18838) ORDERED:

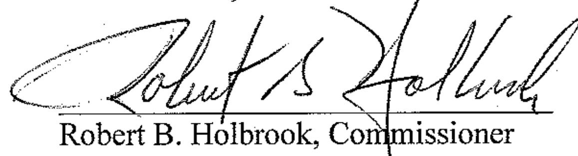
1. The System Pressure factor of $0.0054 per therm filed on September 1, 2006 by National Grid is approved for effect November 1, 2006.
2. The Environmental Response Cost credit factor of ($0.0019) per therm filed on August 1, 2006 by New England Gas Company is approved for effect November 1, 2006.
3. The Weather Normalization factor of $0.0027 per therm filed on August 1, 2006 by New England Gas Company is approved for effect November 1, 2006.
4. The reconciliation credit factor of ($0.0009) per therm filed on September 1, 2006 by National Grid is approved for effect November 1, 2006.
5. The On-System Margin Credit factor of ($0.0041) per therm filed on August 1, 2006 by New England Gas Company is approved for effect November 1, 2006.
6. The Earnings Sharing Mechanism credit factor ($0.0009) cents per therm proposed on September 1, 2006 by National Grid is approved for effect November 1, 2006.
7. The overall Distribution Adjustment Clause charge of $0.0003 per therm is approved for effect November 1, 2006.
8. National Grid shall comply with all other findings and instructions contained in this Report and Order.

EFFECTIVE NOVEMBER 1, 2006 AT WARWICK, RHODE ISLAND PURSUANT TO OPEN MEETING ON OCTOBER 31, 2006. WRITTEN ORDER ISSUED JANUARY 24, 2007.



PUBLIC UTILITIES COMMISSION

Elia Germani, Chairman



Robert B. Holbrook, Commissioner

Mary E. Bray, Commissioner