State of Rhode Island and Providence Plantations

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Patrick C. Lynch, Attorney General

December 11, 2006

Via Electronic Mail and Regular Mail

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

Re: Interstate Navigation Company – General Rate Filing – Traditional Rates – Docket No. 3762

Dear Ms. Massaro:

Enclosed for filing in the above-captioned proceeding are the original and nine (9) copies of the Rhode Island Division of Public Utilities and Carriers' Response to the Commission's First Set of Data Requests.

Many of the Commission's questions went to the issue of the differences in the proposed Interstate Settlement [and attendant Performance Based Regulatory (PBR) plan] and that of other utilities with approved PBR plans and settlements, such as National Grid. While the attached responses provide answers to the specific questions posed, the Division would like to take this opportunity to explain further our rationale for supporting the proposed Settlement and to put the Commission's review of the proposed Settlement in a context appropriate for a company such as Interstate Navigation.

By way of background, the Division notes that the proposed Settlement is the first of its kind for Interstate. There are obvious differences between a small local company such as Interstate and a large multi-national utility such as National Grid, for which the Commission has already approved a performance-based regulatory (PBR) plan and rate-making approach. National Grid (Rhode Island) has annual revenues in excess of $700 million, and its Rhode Island operations are but one component of a multi-national corporation. It has numerous financial resources, financing options, and access to capital markets. National Grid faces no competition for its delivery and transmission service, and it provides a product for which demand is relatively inelastic.

Interstate Navigation on the other hand is a family-owned, privately held business with far fewer financial resources and more limited access to capital. Current total revenues of Interstate are a little more than $8 million. Additionally, while Interstate provides a lifeline service to those who live on Block Island, the vast majority of its revenues are derived from services which are discretionary in nature and subject to competition from a variety of sources. Even though Interstate has just acquired the assets of Island High-Speed Ferry, one cannot conclude that it does not continue to face competition going forward.

Competition comes from many sources. There is a high-speed ferry that runs from New London to Block Island during the summer. The recent implementation of that ferry has not only impacted Interstate, but has also impacted the ridership of the former Island High Speed Ferry as well. There is also the competition for the discretionary leisure dollar from the high-speed ferry that runs from Quonset Point, RI to Martha's Vineyard, MA. This service just completed its second year of operation. Ultimately, Interstate's profitability is subject to the attractiveness of the destination, Block Island, to day-trippers and vacationers versus the whole panoply of other options for leisure and recreational activities. Interstate, as a transportation company in business to service the demands of the populace to travel to Block Island from its Rhode Island departure points, has very little control over these factors.

Interstate operates its 364 days per year (no service on Christmas day). The Company serves passengers, vehicles, and freight, including necessities such as propane, fuel oil, gasoline, and every other commodity necessary to support year-round habitation. This is the "lifeline" aspect of its operation. The aforementioned high-speed ferry from New London does not operate year round and is passenger-only, and the Island High Speed Ferry Company did not operate in the mid-October through May period. There is a large drop off in demand for service to Block Island after September. This aspect of seasonality combined with the discretionary nature of the service adds much more risk to a company like Interstate compared to an electric or gas distribution company.

Interstate bears the additional risk of the impact of poor weather on its ridership in the peak summer months. Rainy weather, especially on summer weekends which would normally be the time of highest utilization, can seriously affect whether the company will operate profitably. This is not dissimilar to the weather related risk of the gas division of National Grid. In that utility's Commission-approved PBR plan there is a Weather Adjustment clause to mitigate this type of risk. In the proposed Settlement with Interstate there is no Weather Adjustment clause, as it is difficult to precisely quantify the impact of weather as simply as we do with the gas company (by measuring the variance of heating degree days from the norm and applying a revenue factor to the variance). Instead of a weather adjustment, the Interstate Settlement contains an Earnings Floor provision that activates at a reported level of 5.5%. In the Division's opinion, significant earnings erosion would be most likely attributable to a decline in revenues as opposed to an increase in allowable, prudent expenses.

As explained further in the attached data responses, the rates of Interstate do not include acquisition costs or acquisition premiums, nor the other elements of concern noted in the first three questions of the Request. The traditional ferry cost of service does include a subsidy of over $330,000 in profits from the fast ferry, which reduces the revenue requirement and rates of passengers, vehicles, and freight on the traditional vessels. Further, with the inclusion of $2.00 of fuel in base rates and a more appropriate fuel recovery in base rates, rather than through the fuel surcharge, the rates for those who travel in off peak months will decline substantially. For example, the fuel surcharge currently in effect is $4.80 per round trip. Added to the commuter rate of $10.00, a total round trip ticket for a commuter is presently $14.80. Effective January 1, that trip will cost $10.50. Similarly, a non-commuter pays a total of $19.10 today, and January 1 will pay $16.55.

Finally, an important consideration for the Division in recommending a PBR approach for Interstate is to limit rate increases in the foreseeable future to an inflationary index, limit the cost associated with the rate filings, and get the management focused on containing its controllable costs and therefore increasing its profitability. The Division has recommended pricing flexibility for the fast ferry operation during the plan term. This flexibility should provide the company with a tool to help maximize its profits on the fast ferry operation which will, in turn, continue to benefit the traditional and lifeline services.

We hope this additional explanation assists the Commission in its review of both the attached data responses as well as the proposed Settlement Agreement. We appreciate the opportunity to provide this additional information.

Very truly yours,

William K. Lueker

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Encl.
cc: Service List PUC Docket No. 3762

CERTIFICATE OF SERVICE

The undersigned hereby certifies that a copy of the within Division Response to the Commission's First Set of Data Requests (with cover letter), was served this 11th day of December, 2006, via first class mail, postage prepaid, as well as by electronic mail, upon each person on the official service list in this proceeding.

William K. Lueker

State of Rhode Island
Before the Public Utilities Commission
Division of Public Utilities and Carriers
Response to Commission Data Requests

1. It is the past practice of the Commission to exclude "acquisition premiums and transaction costs" related to a merger/acquisition of one utility by another. (See Order Nos. 17381 and 16200). The proposed Settlement Agreement appears not to contain similar language regarding the acquisition of Hi-Speed Ferry by Interstate. Please explain why it does not.

Response:
The Hi-Speed Ferry operations are not integrated with the traditional service for financial reporting purposes. Rather, the Hi-Speed Ferry will operate as a separate division. Therefore the "acquisition premiums and transaction costs" related to the Hi-Speed Ferry will automatically be excluded from the traditional ferry cost of service, although not explicitly stated in the proposed Settlement Agreement. The only thing that will appear in the traditional ferry cost of service is a credit from the Hi-Speed Ferry division.

Prepared by: David J. Effron on behalf of the Division of Public Utilities and Carriers
December 11, 2006

2. Pages 12-13 of Order No. 18728 indicate that the purchase price of Hi-Speed by Interstate was $5,612,500 and paid for "goodwill" and "non-compete", as well as a DPCN and a berthing permit. Please explain if and why ratepayers should pay for such items in the future.

Response:
Ratepayers are not paying for "goodwill" and "non-compete", as well as a DPCN and a berthing permit, and will not do so in the future under the terms of the Settlement. As noted in the prior response, the only effect on the traditional ferry cost of service of acquiring the Hi-Speed Ferry is a credit from the Hi-Speed Ferry division. Thus, the traditional cost of service can only be reduced as a result of the Hi-Speed acquisition, and traditional ratepayers are not paying any of the costs associated with the acquisition.

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December 11, 2006

3. Pages 12 of Order No 18728 indicates that the appraised value of M/V Athena was $4.2 million. Indicate what was the net book value of the M/V Athena. If the net book value is below the appraised value, please explain why ratepayers should pay for the difference.

Response:
The Division is not aware of the net book value of the M/V Athena in the hands of the previous owner. As explained in the prior response, traditional ratepayers are not paying the costs associated with the acquisition, including any difference between the net book value and the appraised value.

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4. Under the proposed Settlement, the earnings sharing is calculated over a five year period. However, NGrid's (gas) earnings are calculated and shared annually. Explain why Interstate's earnings sharing should not be calculated and shared annually.

Response:
Interstate's earnings are subject to significant fluctuations due to factors such as weather. Calculating the earnings sharing over a five-year period provides an opportunity to stabilize and normalize the effect of such fluctuations. The earnings of the Gas Company also fluctuate based on weather, but the Gas Company has a weather normalization clause that mitigates the effect of weather and reduces the need for inter-year normalization. Interstate has no such weather normalization clause.

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5. List Interstate's ROE on an annual basis for the last ten fiscal years.

Response:
The Division does not have Interstate's ROE on an annual basis for the last ten fiscal years available.

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6. Under the proposed Settlement, earnings are only shared on a 50/50 basis between the ratepayers and the company, unlike the earnings sharing for NGrid (electric and gas) which also occurs on a 75/25 basis. Please explain why there is no sharing at some earnings level whereby ratepayers receive 75% of excess earnings.

Response:
It was the Division's position in testimony that the earnings sharing should include a 75/25 tier. However, as part of the compromises leading to the Settlement, the Division agreed to eliminate this tier and have all earnings above the defined threshold shared 50/50. A factor taken into account by the Division in reaching this compromise was the degree of competition faced by Interstate (even with the acquisition of Hi-Speed Ferry) compared to National Grid.

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December 11, 2006

7. Pursuant to provision II.B.3 of the proposed Settlement, please indicate whether Interstate is entitled to an increase if its ROE is below 5.5% or instead must go through a short rate proceeding with the Commission to prove it needs additional revenues?

Response:
Any such increase is subject to Commission approval, including a hearing if there are any contested issues or any other matters requiring investigation or public comment.

Prepared by: Steve Scialabba, Chief Accountant, Division Of Public Utilities And Carriers
December 11, 2006

8. Why is the date of November 15 used for a rate filing for an increase if the ROE falls below 5.5% when the Interstate fiscal year ends in May? Why isn't the date for a rate filing set on September 1?

Response:
The Division agreed to this date because the Company indicated that it needed that much time to assemble the required information.

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December 11, 2006

9. If, pursuant to II.B.3 of the proposed Settlement, Interstate can seek a rate increase when its ROE is below 5.5% in any given year, why should there not be earnings sharing for any given year when the ROE exceeds a high amount such as 16.5%?

Response:
The Settlement calls for earnings sharing, computed at the end of the five years if the average aggregate ROE exceeds the specified threshold. Thus earnings when the ROE exceeds a high amount such as 16.5% will ultimately be shared unless offset by lower earnings in other years.

Prepared by: David J. Effron on behalf of the Division of Public Utilities and Carriers
December 11, 2006

10. Why does earnings sharing begin at 12.5% instead of where the ROE is set (11.0%), which is the case for NGrid (gas and electric)?

Response:
Both National Grid electric and gas divisions include "shared savings" allowances in their costs of service. Interstate has no such allowance. Accordingly, Interstate was allowed a "dead zone" above the authorized ROE where 100% of earnings could be retained.

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December 11, 2006

11. What was the ROE set in the last Interstate rate case docket and explain if and why the ROE for Interstate has increased if Hi-Speed Ferry is no longer a competitor?

Response:
The authorized ROE in the last case was 10.75%. The existence of Hi-Speed Ferry as a competitor is only one of many factors affecting the risk and cost of equity to Interstate. For example, the Division notes that other competition still exists, and interest rates at the present are generally higher than at the time of the Interstate's last rate case. The negotiated ROE of 11% cannot be looked at in isolation from the context of the Settlement as a whole.

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12. In contrast to provision II.D.1, can the Commission require the calculation of the cumulative ROE prior to the end of the Rate Plan?

Response:
The Division believes that the Commission has the authority to require such a calculation.

Prepared by: Steve Scialabba, Chief Accountant, Division Of Public Utilities And Carriers
December 11, 2006

13. In the event the Commission approves a proposed multi-year Settlement between the parties, do the parties recognize that the Commission has an ongoing obligation to modify rates to protect the public against improper and unreasonable rates and, therefore, the Commission can end the Settlement if it deems it in the public interest at anytime?

Response:
The Division recognizes this authority.

Prepared by: Steve Scialabba, Chief Accountant, Division Of Public Utilities And Carriers
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