NATIONAL GRID

DISTRIBUTION ADJUSTMENT CLAUSE FILING

RIPUC DOCKET NO. 3859

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 17, 2007

RIPUC DOCKET NO. 3859
DIRECT TESTIMONY
OF DAVID J. EFFRON

TABLE OF CONTENTS

I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 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, 2007, National Grid ("the Company") filed the Earnings Sharing calculation for the operations of the former New England Gas Company ("NEG") for Fiscal Year 2007. 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 2007 reflect ownership of the NEG assets by Southern Union prior to that date and ownership by National Grid subsequent to that date.

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. However, I am proposing to modify the Company's proposed "hold harmless" mechanism related to the effect of the acquisition on the balance of accumulated deferred income taxes ("ADIT") reflected in the calculation of rate base.

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, 2007 ("FY2007")?

A. Yes. The Company calculated that it earned a return on common equity of 0.36% in FY2007, resulting in a zero credit to customers for earnings sharing (Attachment MDL-1, Page 1 accompanying the testimony of Mr. Laflamme).

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

A. Yes. I have reviewed the calculation of the return on common equity ("ROE") presented by the Company. My examination included an analysis of the Company's financial statements for the twelve months ended June 30, 2007, 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 FY2007 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 $20 million. I have not identified potential adjustments that would, in sum, even approach this magnitude.

Q. The return on equity of 0.36% is a significant decrease from the returns reported in Fiscal Year 2005 and Fiscal Year 2006. To what do you attribute this decrease?

A. I have prepared a comparison of the components of the earned return on equity in Fiscal Years 2005, 2006 and 2007 on my Schedule DJE-1, Page 1. I have begun in the first column with the return on common equity in FY2005 as calculated by the Company in its compliance filing in Docket No 3690. The next column is the earned return on equity in FY2006 as presented by the Company in Docket No. 3690. The third column is the return on common equity in Attachment MDL-1 in this case. As can be seen on this schedule, the main reason for the decrease in the earned return on equity is that operation and maintenance expenses increased substantially from 2005 to 2007. An increase in taxes other than income taxes of approximately $3.8 million from 2006 to 2007 also contributed to the decrease in the earned return on equity over that period.

Q. Have you analyzed the increase in operation and maintenance expense from FY2005 to FY2007?

A. Yes. I show the operation and maintenance expense by function on Schedule DJE-1, Page 2. The largest increases in operation and maintenance expense from 2005 to 2006 were in the areas of distribution maintenance - $1.9 million and customer accounts - $5.6 million. The increase in operation and maintenance expense from 2006 to 2007 was due mainly to an increase in distribution maintenance expense of $7.9 million, which was partially offset by a net decrease to other expenses.

Q. Has the Company explained the increases in expenses from 2005 to 2007?

A. In Docket No. 3760, the Company explained the increase in expenses from 2005 to 2006, stating that the increase in distribution maintenance expense was the result of an increase in security services and a change in the method of allocating supervisory labor time and that the increase in customer accounts expense was due mainly to the cost of increased collection efforts and an increase in uncollectible accounts expense.

With regard to the increase in expenses from 2006 to 2007, the Company stated that it is not able to explain the increases in operation and maintenance expense by account because of changes in the accounting for certain activities subsequent to the merger, which made comparisons of particular expenses in 2006 and 2007 difficult. The Company was able to explain that the increase in taxes other than income taxes was the result of an increase in gross earnings tax (GET) from 2006 to 2007. Based on the Company's explanation, the increase in GET appears to be related mainly to errors, which when corrected would reduce the expense for the twelve months ended June 30, 2007.

Q. Are you proposing any adjustments to operation and maintenance expenses or GET for the purpose of the ESM calculation?

A. No. I not believe that the increases in operation and maintenance have been satisfactorily explained in all cases. However, even if I were to recommend that the operation and maintenance expense reflected in the FY2007 ESM calculation be frozen at the FY2005 level and were to make the necessary corrections to the GET, 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 subsequent to the acquisition of the NEG assets. That filing is now expected to take place in 2008, based on the Company's representations in its letter to the Division of June

19, 2007. 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.

IV. HOLD HARMLESS MECHANISM

Q. In calculating its earned return on equity, did the Company include a "customer hold harmless credit" in operating revenues?

A. Yes. The Company reflected a hold harmless credit of $1,466,559.

Q. What is the purpose of the hold harmless credit?

A. The acquisition of NEG by National Grid was structured as a purchase and sale of assets. At the time the assets were acquired, a new tax basis for those assets, including plant in service, was established. That new tax basis was equal to the acquisition cost of the assets – deemed to be the assets' book value. As the tax basis at the time of acquisition equaled the book basis, the accumulated deferred income taxes ("ADIT") existing at that time were eliminated. In effect, the acquisition resulted in the deferred tax liability coming due and being paid. Thus, the ADIT balance was no longer available to reduce rate base, and the rate base increased accordingly. The purpose of the hold harmless credit is to put ratepayers in the same position as they would be if the balance of ADIT had not been eliminated by the acquisition.

Q. How did the Company calculate the hold harmless credit?

A. The Company calculated what the ADIT on the acquired assets would have been from the time of the acquisition going forward under continuing Southern Union ownership and what the ADIT on the acquired assets will be from the time of the acquisition going forward under National Grid ownership. The current authorized pre-tax rate of return was then applied to the differences in the ADIT balances for each year over the remaining lives of the acquired assets. This represents the annual increase in revenue requirements related to the loss of the ADIT.

The Company calculated the net present value of the annual increase in the revenue requirements to be $22.1 million. Amortizing that present value over twenty years with a return, the annual hold harmless credit is $2.9 million, the amount necessary to offset the effect of loss of the ADIT. The hold harmless credit included in the FY2007 return on equity calculation represents one-half of the annual credit, as the ESM calculation reflected elimination of the ADIT for one-half of FY2007.

Q. Do you agree that a hold harmless credit is appropriate?

A. I agree in principle. However, I recommend that the mechanism be modified so that the credit to ratepayers better tracks what the ADIT balance would have been in the absence of the acquisition.

Q. How should the mechanism be modified?

A. On Exhibit MDL-2, the Company shows the ADIT on the acquired assets under continuing Southern Union ownership and the ADIT on the acquired assets under

National Grid ownership. I have summarized the ADIT balances and the differences in the balances as of December 31, 2006 and the years following on my Schedule DJE-2. Rather than including a hold harmless credit in revenues, I recommend that the difference in the ADIT balances, as shown on this schedule be deducted from rate base. For example, if the Company has a future rate case with calendar 2008 as a test year, the rate base deduction would be the average of the December 31, 2007 and December 2008 balances, or $32,005,000. This amount would appear as a rate base deduction labeled "ADIT Merger Adjustment." If necessary, the balance as of any date in the year other than December 31 could be calculated by interpolation. For example, the balance as of March 31, 2009 would be 3/4*$28,542,000 + 1/4*$27,345,000, or $28,243,000.

Q. What is the advantage of the hold harmless mechanism that you are proposing over the mechanism proposed by the Company?

A. I see three advantages. First, the method I am proposing more closely tracks the actual revenue requirement effect of the lost ADIT. For example, the customers in 2009 will be held harmless from the actual loss of the ADIT in that year, rather than the present value of the loss of the ADIT normalized over twenty years. Second, if the authorized rate of return changes, this method will capture the effect of that change, rather than assuming that the rate of return remains fixed over the period during which the ADIT difference exists. Third, this method avoids the necessity of having to make an arbitrary assumption regarding the appropriate period over which to normalize the present value of the savings. The Company has chosen a twenty year period. This is not clearly unreasonable, but there is no obvious reason why it is better than a period of fifteen years or twenty-five years.

Q. Why does your proposed schedule of rate base deductions for the ADIT Merger Adjustment end in 2022, although the difference in ADIT balances will continue to exist well after 2022?

A. The present value of the return on the ADIT differential is relatively small in the years subsequent to 2022. The differential remains positive in 2023 and 2024 but then turns around and goes negative in the following years. (That is, the ADIT balance in the years after 2024 is generally greater under National Grid ownership than it would have been under continuing Southern Union ownership.) The present value of the return on the positive balances is approximately the same as the present value of the return on the negative balances after 2022.

Thus, by ending the rate base deductions in 2022, the mechanism achieves substantially the same end result on a present value basis as would continuing the rate base adjustments through 2053. However, the need to make rate base additions in the years 2025 through 2038 is avoided, as is the necessity of dealing with relatively immaterial balances after 2038.

Q. Does this conclude your direct testimony?

A. Yes.

NATIONAL GRID
COMPARISON OF RESULTS OF GAS OPERATIONS
FISCAL YEARS ENDED JUNE 30, 2005, JUNE 30, 2007 AND JUNE 30, 2007
($000)

	(1) FY2005	(2) FY2006	(3) FY2007
Revenue	$ 410,617	$ 459,740	$ 447,708
Cost of Gas	261,341	312,661	298,469
Margin	149,276	147,079	149,239
O&M Expense Excluding Purchased Gas	76,971	85,476	89,485
Depreciation and Amortization	20,753	22,238	22,267
Other Taxes	22,243	21,203	24,954
Income Taxes	7,000	2,821	509
Operating Expenses Excluding Purchased Gas	126,967	131,738	137,215
Operating Income	22,308	15,341	12,025
Interest on Short-Term Debt	674	1,047	1,275
Interest on Long-Term Debt	8,724	8,980	9,757
Other Interest	118	134	140
AFUDC	(207)	(59)	(93)
Total Interest Expense	9,308	10,102	11,079
Net Income	13,000	5,239	946
Preferred Dividends	461	475	515
Net Income for Common Equity	$ 12,539	$ 4,764	$ 431
Common Equity	$ 106,567	$ 109,696	$ 119,040
Return on Common Equity	11.77%	4.34%	0.36%

Sources:
(1) SP-3 Compliance Filing, Docket No. 3690
(2) Attachment SP-1, Pages 1 and 2, Docket No. 3760
(3) Attachment MDL-1, Pages 1 and 2

NATIONAL GRID
COMPARISON OF GAS O&M EXPENSE
FISCAL YEARS ENDED JUNE 30, 2005, JUNE 30, 2007 AND JUNE 30, 2007
($000)

	(1) FY2005	(2) FY2006	(3) FY2007
Storage Expense	$ 914	$ 1,023	$ 1,232
Distribution Operation	12,887	13,840	11,236
Distribution Maintenance	6,377	8,244	16,185
Customer Accounts	17,403	22,966	20,385
Customer Service and Information	529	646	1,495
Sales	365	403	148
Administrative and General	34,715	33,230	36,466
Corporate Allocation	2,188	3,265	-
Eliminations and Adjustments	(456)	(190)	289
Shared Savings	2,049	2,049	2,049
Total Operation and Maintenance Expense	$ 76,971	$ 85,476	$ 89,485

Sources:
(1) SP-3 Compliance Filing, Docket No. 3690
(2) Attachment SP-1, Page 2, Docket No. 3760
(3) Attachment MDL-1, Page 2
A&G shown net of elimination of costs to achieve

NATIONAL GRID
MERGER ADJUSTMENT TO ADIT
($000)

As of 31-Dec	* Southern Union ADIT	* National Grid ADIT	Difference	** Southern Union ADITC	ADIT Merger Adjustment
2006	34,845	214	34,631	928	35,559
2007	33,908	1,238	32,670	724	33,394
2008	32,170	2,073	30,097	519	30,616
2009	30,086	1,859	28,227	315	28,542
2010	29,473	2,238	27,235	110	27,345
2011	29,632	3,184	26,448		26,448
2012	29,583	3,760	25,823		25,823
2013	29,515	4,286	25,229		25,229
2014	29,199	4,628	24,572		24,572
2015	29,095	5,530	23,566		23,566
2016	28,823	6,531	22,292		22,292
2017	28,342	7,568	20,774		20,774
2018	27,627	8,606	19,020		19,020
2019	26,847	9,842	17,005		17,005
2020	25,922	11,305	14,617		14,617
2021	24,732	12,797	11,934		11,934
2022	23,374	14,311	9,064		9,064

ADIT = Accumulated Deferred Income Taxes
ADITC = Accumulated Deferred Investment Tax Credits

Source: Attachment MDL-2