State of Rhode Island and Providence Plantations
Public Utilities Commission

In Re: National Grid –
Request for Change in Gas Distribution Rates

Public Utilities Commission
Docket No. 3943

POST-HEARING MEMORANDUM OF THE DIVISION OF PUBLIC UTILITIES AND CARRIERS

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I. INTRODUCTION

On April 1, 2008, National Grid ("NGrid" or the "Company") filed a request to increase gas distribution rates by $20.4 million per year. Along with the proposed rate increase, NGrid also seeks Commission approval of (1) a "full" revenue decoupling mechanism; (2) an Accelerated Pipe Replacement Program ("APR Program") advanced principally by the deployment of a fully reconciling "capital tracker" rate mechanism; (3) a fully reconciling "pension tracker" rate mechanism; and lastly (4) a ratepayer funded "gas marketing program." Leaving aside its request for a substantial rate increase during a period in which Rhode Island ratepayers have experienced some of the highest utility bills in history, each of the four additional requests described above represent a significant departure in the way Rhode Island's only gas utility will be regulated.

In addition to recommending a number of adjustments to the Company's proposed revenue requirement and other rate design modifications as more fully described herein, the Division cannot support any of the other requested changes described above with one exception – the APR Program and the deployment of a "capital tracker" rate mechanism given that the current status of pipeline infrastructure and public safety considerations sanction a departure from traditional regulation at this time. However, the three remaining proposals (*i.e.,* revenue decoupling, pension trackers, and a ratepayer-funded gas marketing program) should not be approved by the Commission since the evidence simply does not demonstrate that any of the proposals are either necessary or in the true interests of ratepayers. To the contrary, the body of evidence in this proceeding actually demonstrates that the remaining proposals are intrinsically designed to enhance shareholder value by either ensuring cost recovery or mitigating corporate risk, while only tenuously or hypothetically advancing the interest of ratepayers. This is not to say that the APR Program along with the capital tracker mechanism do not advance shareholder interests – they absolutely do. As concretely displayed in National Grid's October 7, 2008 presentation to shareholders, one of the most important ways National Grid intends to advance shareholder value is through increased investments where cost recovery is assured.[1] The capital tracker mechanism accomplishes this goal by allowing NGrid to make investments (and thus generate greater returns) without compromising cash flow since the incremental capital expenditures will be tracked and automatically recovered in rates without a formal rate case. Had it not been for the compelling evidence that the interests of ratepayers and public safety sanctioned the accelerated replacement of aged pipeline infrastructure (along with the concomitant deployment of the capital tracker rate mechanism), the Division would not have supported the proposal. However, the Division believes that the evidence in the case adequately

[1] Exhibit DIV-69, at 39 (see Attachment A).

demonstrates that the APR Program is an appropriate and necessary interim measure to make up for documented deficiencies in the maintenance of the system. Accordingly, the Division submits that the weight of the evidence demonstrates that ratepayer interests are best advanced and protected if the Commission denies the Company's unprecedented requests with the sole exception pertaining to the accelerated pipe replacement program.

II. COST OF CAPITAL – "We are a very low risk business"[2]

We begin with an important piece of evidence that came late in the proceeding; that is, according to National Grid's own Chairman and Chief Executive Officer, National Grid is an "extraordinarily low risk" company with very solid returns.[3] By its very nature, this statement means that National Grid portrays the composite risk of its regulated and unregulated operations as very low in the context of an investor's full range of options, including other utilities both domestically and abroad. Yet, within the four corners of the regulatory ratemaking process, the Company seemingly claims the opposite is true by seeking a return on equity of 11.5% that is 90 basis points above the historical return of the market from 1926 to 2007 of 10.4%. This inaccurate cost of equity is then applied to a capital structure that is completely at odds with how National Grid, PLC (the holding company) actually finances the utility operations in Rhode Island. By

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[2] National Grid's "Investor Day" Presentation, October 2008, Ex. DIV-69, at 6 (see Attachment B).
[3] Exhibit DIV-70.

advancing a higher ratio for equity to debt, even though the operations are actually funded with a lower percentage of equity, the Company is able to hold true to its shareholder pledge to consistently make investments with "returns above our cost of capital."[4]

Thus, if this Commission accepts National Grid's assertion that the Company's capital structure should be based on "hypothetical capital structure ratios"[5] because National Grid's capital structure is not typical of the natural gas distribution business, ratepayers will unnecessarily pay higher bills without any corresponding benefit. In fact, this is precisely what National Grid, PLC wants: regulated operations carrying the "equity burden" for the overall holding company, which enables that same holding company to have access to very low cost debt to finance its unregulated enterprises while at the same time enhancing earnings for shareholders. The result – while unnecessarily increasing the costs to the captive customers of its regulated operations in the U.S., brings tremendous value to shareholders, as candidly admitted by Mr. Holliday during a recent interview: "We only invest when we know we can <u>lock in a return over our cost of capital</u>."[6] Unfortunately, the "win-win" that we often heard about during the hearing process is clearly for the company and its shareholders – not for ratepayers. In a nutshell,

[4] Exhibit DIV-69, at 7 (see Attachment C).
[5] See page 10, lines 1-2 of Mr. Moul's rebuttal testimony.
[6] See Interview of Steve Holliday, CEO of National Grid, PLC, "The Cantos Transcript," Exhibit DIV-70, at 2 (Emphasis supplied).

if this Commission adopts the Company's proposed capital structure, which is clearly at odds with how National Grid finances the Rhode Island operations, and further approves an ROE at or near 11.5% (which would remain the highest authorized ROE of any National Grid gas operation in the US),[7] the result will be the envy of utilities around the world by allowing National Grid to achieve the "great combination" of "very secure returns, very secure cash flows and a business that is growing."[8] As discussed in more detail below, neither the evidence nor the public interest can permit such an outcome.

A. Capital Structure

The level of common equity used in the capital structure to compute the overall cost of capital should be no higher than the percentage of common equity the Company actually expects to use.[9] Accordingly, the Division's witness, Mr. James Rothschild, has recommended the use of a capital structure containing 37.77% common equity because (1) it represents the actual capital structure of the holding company, National Grid, PLC; and (2) the debt rating of the Rhode Island operations of National Grid, PLC as determined by Standard & Poors is strictly dependent upon the financial conditions of the holding company, National Grid, PLC. That conclusion is not undermined by the holding company's "remote

[7] Exhibit DIV-69, at 112 (see Attachment D).
[8] Statements of NGrid CEO Steve Holliday, Exhibit DIV-71, at 2.
[9] Direct testimony of James Rothschild, Ex. DIV-5, at 4-6.

parent, non-domestic" status, as claimed by NGrid witness Paul Moul.[10] Moreover, Mr. Moul's arguments that the "rate setting process is radically different in the United Kingdom than we use here in the US"[11] or that "the capital structure contains ratios that are not typical of the gas distribution business"[12] provide no meaningful basis to undermine Mr. Rothschild's conclusion that the actual capital structure of National Grid, PLC is the capital structure that should be used for the Rhode Island gas operations. Asked why National Grid would maintain the current 90% common equity ratio for Narragansett Electric if the capital structure established by the commission was 37%, Mr. Rothschild's explanation is highly instructive:

> Because the subsidiary level common equity ratio, if it's high, doesn't matter because that is not really equity. It's not really equity. It's not the equity that's out there being traded in the marketplace, it's not the equity that was raised from common equity holders. What you have there . . . [as] being shown as equity on the books of Narragansett Elecric has been provided through debt sources from the parent entity.[13]

Mr. Rothschild also demonstrated during his cross-examination that all of the arguments made by Mr. Moul against the use of National Grid, PLC's actual capital structure were invalid. For example, when Mr. Rothschild was asked a line

[10] September 10, 2008 Transcript at 9.
[11] *Id.*
[12] September 10, 2008 Transcript at 10.
[13] September 11, 2008 Transcript at 11.

of questions regarding possible issues that would make the appropriate capital structure in the UK different than in the US, his reasoning was logical:

> The bottom line here is that whether you're in the UK, the US, Antarctica, or on the moon, the principle holds that bond investors want to have a reasonable opportunity to get their money back: stock investors want a reasonable opportunity to earn a fair return, and more and more every day this is a world market and indeed National Grid, PLC, having approximately half of its utility operations in the US in and of itself shows the international, not intergalactical, but international nature of the business. [14]

Any potential concerns regarding National Grid, PLC's status as a UK firm have explicitly been considered in financial statements through the application of GAAP standards and bond rating reports.[15] The *regulatory process* in the UK may be different, but the accounting principles used to assess the financial health of the entity, and thus the appropriateness of the capital structure, remain the same.[16] National Grid, PLC's "resulting bond rating is fine and so with an A minus bond

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[14] See page 76, lines 16-24 and page 77, lines 1-8 of the transcript from hearings on September 11, 2008

[15] Thus, for example, in the UK one would see lower "allowed" returns, but this is simply based on a higher valuation for assets used to calculate the return. It has no significance on judging the propriety of the overall capital structure.

[16] During the hearings, there was a discussion about the inconsistency of using the actual cost of debt for National Grid while at the same time using a hypothetical capital structure that contains a higher level of common equity than actually being used by National Grid. A graph on page 4 of Mr. Rothschild's surrebuttal testimony shows the actual relationship between capital structure and bond rating. Mr. Rothschild further explained that at a minimum, if the hypothetical capital structure were used instead of National Grid's actual capital structure, consistency would require a pro-forma adjustment to lower the cost of debt. This adjustment would bring the cost of debt of National Grid down to the level that it would have been able to obtain if it had actually implemented its hypothetical capital structure. However, the Division must emphasize that merely lowering the embedded cost of debt would not be enough to justify the use of the hypothetical capital structure advanced by the Company. The higher weighted cost of equity, and the higher income tax allowance associated with the higher weighted cost of equity would both be unnecessarily expensive for ratepayers and provide a return on capital to National Grid that would be considerably higher than its actual cost of capital.

rating I don't see any reason why the company . . . should be expected to have pressure to increase its common equity ratio."[17]

Moreover, the sound financial condition of National Grid, PLC specifically reflects the more risky unregulated activities that the company is currently pursuing.[18] Accordingly, the use of the consolidated capital structure of National Grid, PLC, as Mr. Rothschild has precisely done in this case, "only produces a <u>conservatively high common equity ratio</u>."[19]

During the hearings, the Company interposed numerous objections to the single most important question facing the Commission, namely whether adopting Mr. Moul's higher equity recommendation (47%) carried <u>any value</u> to ratepayers given that the Rhode Island operations would still be financed by the UK holding company that maintained a much lower equity percentage (37%). Despite the procedural interference on an issue that arguably represents the "holy grail" for a public utility seeking a rate change, the validity of Mr. Rothschild's conclusions were crystallized in the record:

> Q. [I]f this Commission were to [approve] a capital structure with higher equity at the Rhode Island level and National Grid, PLC continued to operate with the current capital structure of 37 % [equity], what in real terms would the Commission have accomplished with that?
>
> A. What the Commission would have accomplished is to have revenues go up and those revenues, by the way, would include an allowance for income

[17] September 11, 2008 Transcript, at122-23. The common equity ratio is naturally higher given the unregulated activities.
[18] September 11, 2008 Transcript, at 120.
[19] September 11, 2008 Transcript, at 121 (Emphasis supplied).

> taxes which would be above and beyond the income taxes actually paid . . . . So you'd have [increased] revenues that . . . would instead go to the higher profits for the parent company.[20]

In other words, not only would Rhode Island ratepayers fund much more costly equity that, in reality, is never actually utilized for the Rhode Island operations, the hypothetical equity would then have to be grossed up for federal income taxes for an overall cost rate of almost 17.7%.[21] It would defy the public interest to take additional ratepayer money[22] for no valid purpose other than bolstering National Grid, PLC's profits or worse, helping to subsidize the cost of capital for the Company's unregulated businesses.[23] Not surprisingly, the Division's position is sanctioned in public utility treatises as a long-established precedent:

> Where a utility is a wholly owned subsidiary which obtains its equity capital through its parent corporation, commissions commonly use the capital structure of the consolidated system . . . a consolidated capital structure is appropriate, for <u>market evaluations of the parent's stock afford the primary evidence of the current cost of equity to the subsidiary . .</u> . Moreover, it would be inappropriate to use either the subsidiary's own cost of debt or its capital structure because the capital structure ratios would be inconsistent with the respective cost rates and the composite cost of total capital would be distorted.

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[20] September 11, 2008 Transcript, at 138-39.

[21] The rates would need to generate $1.54 for every incremental dollar of equity return (assuming a marginal corporate income tax rate of 35 %).

[22] Best expressed by Commissioner Holbrook during the hearings as a "detrimental effect on rates." Tr. 9/11/08, at 127.

[23] If the Company successfully convinces US regulatory commissions to award the proxy capital structures advanced by Mr. Moul, it would have the overall effect of having all of the holding company's equity provided by regulated companies (and their captive ratepayers) and at the same time allow the holding company to essentially use nothing but low-cost debt to finance the unregulated businesses (an all too familiar practice called "leveraging"). The Commission cannot allow Rhode Island ratepayers to be used in such a fashion when there is no sound basis in the record for doing so.

Charles F. Phillips, Jr., The Regulation of Public Utilities Theory and Practice, Part 2, Ch. 9, pg. 18 (Public Utilities Reports 1988) (Emphasis supplied).

B. Cost Of Equity

The record in this case shows that the 9.95% cost of equity recommendation of Mr. Rothschild is well supported. It is consistent with financial facts and generally accepted financial theories. It is also consistent with the Commission's prior decisions to rely on the Discounted Cash Flow ("DCF") method and to rely on the "b x r" form of the DCF method.[24] As stated by the Commission:

> In determining the cost of common equity over the last several years, this Commission has consistently stated its preference for the use of the discounted cash flow (DCF) methodology with the expected growth rate determined through the "b x r" or retention growth rate method.[25]

The Commission's holding follows an earlier pronouncement in a case involving one of National Grid's predecessors:

> This commission has stated with considerable clarity its position on the risk premium analysis, and the general approach to be taken with regard to the discounted cash flow (DCF) methodology. With regard to the risk premium methodology, we have repeatedly rejected it as a viable means of determining the cost of equity.[26]

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[24] Mr. Rothschild explains that the "b x r" method is a special form of the DCF, and that "(w)hat makes it special is its applicability to the constant growth form of the DCF model." Ex. DIV-6, at 14. The "b x r" form of estimating growth is the only form of the DCF model that is part of the constant growth form of the model.

[25] In re: Valley Gas Company and Bristol & Warren Gas Company, Docket No. 2276, Order No. 14834, at 12 (October 18, 1995).

[26] In re: Providence Gas Company, Docket No. 1971, Order No. 13534, at 12 (October 18, 1995); In re: Providence Gas Company, Docket No. 1914 (1989), Order No. 12974, at 14.

Ratemaking treatises also support the Commission's long-established policy: "The DCF method of determining the return on equity is perhaps the most commonly used method for computing cost of equity among the regulatory agencies today." *Leonard Saul Goodman, The Process of Ratemaking, Vol. 1, Pt. 9, 617 (2005 WL 998304).* The DCF method "has become the most popular technique of estimating the cost of equity, and it is generally accepted by most commissions. Virtually all cost of capital witnesses use this method, and most of them consider it their primary technique." *James C. Bonbright et. al., Principles of Public Utility Rates, Pt. 3, Ch. 14 (2d ed.).* Even the Federal Energy Regulatory Commission utilizes the DCF formulation in determining return on equity in generic proceedings. *Leonard Saul Goodman, The Process of Ratemaking, Vol. 1, Pt. 9, 619 n.1 (2005 WL 998304).*

As shown on Schedule JAR 3,[27] Mr. Rothschild applied the DCF method to a comparative group of gas companies. The DCF model is generally implemented by adding the dividend rate to an estimated growth rate.[28]

Mr. Rothschild also presented the CAPM method to verify his ROE conclusion.[29] His method maximizes the accuracy obtainable from the risk premium approach because he uses actual earned return data from 1926-2007

[27] Exhibit DIV-5, Schedule JAR 3.
[28] Exhibit DIV-5, at 10. Mr. Rothschild explains that the constant growth form of the DCF model can be properly used only if earnings, book value, dividends, and stock price are all estimated to grow at the same rate. He correctly notes that the ROE "x" retention rate computation results in the constant growth rate quantification that is required for use in the DCF model.
[29] Exhibit DIV-5, at 24.

divided into portfolios with different betas. Because he relied on the actual quantification of different returns by beta, his CAPM approach allowed him to show the historic actual return that is consistent with the beta of a comparative group of gas companies covered by Value Line. By directly analyzing the actual earned return, he avoids the error-producing step of separately estimating the risk free rate.[30] The only adjustment Mr. Rothschild made to the historic actual data was to make a correction to recognize that today's investors expect future inflation to average 2.65% rather than the historic actual 3.0%.[31] Mr. Rothschild's CAPM analysis determined the relationship between beta and historical returns for 10 groups of companies from 1926-2007. A beta of 1.0 earned a compounded annual return of 10.40% for its equity investors over this time period. The average beta for the comparative gas companies chosen by the company witness is 0.85, indicating that the non-diversifiable risk for these gas companies is 85% of the average risk.[32] The least squared equation indicates that the earned return to stockholders who invested in a portfolio with a beta of 0.88 earned a compounded annual return of 9.72% from 1926-2007.[33]

However, the current inflation expectation demanded by investors is 2.65% (see JAR Schedule 6, page 1), or 0.35% lower than the inflation rate embedded in

[30] See Graph 1 on page 30 of Mr. Rothschild's direct testimony, Ex. DIV-5.
[31] The results of that adjustment are shown on JAR Schedule 6, page 1 of Mr. Rothschild's testimony, Ex. DIV-5.
[32] Mr. Rothschild Direct Testimony used a comparative group of 9 gas companies with an average beta of 0.88.
[33] The compounded annual average historical actual return earned by companies with a beta of 1.0 was 10.40%, corresponding to a 9.72% historical actual return earned by companies with a beta of 0.88 during a period of time when the compound annual rate of inflation averaged 3.0%. Direct testimony of James Rothschild, Ex. DIV-5, at 27.

the historical actual return numbers. Therefore, to make the historical returns consistent with investors' current inflation expectations, the 9.72% should be reduced by 0.35%. This 9.72% return adjusted for the current inflation expectation results in a 9.37% CAPM indicated cost of equity for gas companies with a beta of 0.88.

C. <u>Deficiencies in NGrid's ROE Analysis and Recommendation</u>

The record in this case demonstrates that although Mr. Moul's DCF happens to produce a result that is similar to the one obtained by Mr. Rothschild, Mr. Moul's DCF methodology is flawed not only because he failed to follow the "b x r" approach that has been favored by this Commission in prior decisions, but also because he adds an <u>unjustifiable</u> 0.54% for a so-called "leverage adjustment" and 0.19% for "flotation costs." Moreover, the basis of his analysis relies on forecasts of earnings-per-share growth as a proxy for long-term sustainable growth. The evidence in the record shows that the "leverage adjustment" goes against basic finance principles, and further, that his growth rate is not reflective of the long-term sustainable growth required by the constant growth form of the DCF analysis.[34]

Next, Mr. Moul performed an "equity risk premium" method that is inconsistent with Commission precedent. Even if the method were accepted, there

[34] See page 57 of Mr. Rothschild's direct testimony, Ex. DIV-5.

are still two serious problems with Mr. Moul's equity risk premium method. The first problem is rooted in financial theory where he inappropriately assumes that equity risk premiums are constant when, in fact, they have actually been decreasing over time. It is only the risk premium as measured against inflation, and not interest rates, that remains constant. The second mistake is mathematical – in that he incorrectly used the arithmetic mean instead of the geometric mean in calculating the premium of S&P Utility Index over public utility bonds.[35]

Lastly, Mr. Moul's CAPM analysis represents an anthology of errors all combined to arrive at an indicated cost of equity that is so high that it simply lacks any credibility whatsoever. The glaring mistakes underlying Mr. Moul's CAPM result are numerous: (1) His use of the arithmetic average is wrong; (2) the DCF approach to compute the risk premium makes the same error he did in his DCF analysis by using short-term analyst forecasts as a proxy for long-term sustainable growth; (3) the use of Value Line's five-year projection of total returns on the stock market as if it were intended to be a reflection of investor expectations when, in fact Value Line has no such intention in mind; and (4) the inflation of the beta as applied to the risk premium repeats the conceptual error he made when applying the leverage adjustment to his DCF method. As a result, the Commission must reject the results of the analysis.

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[35] See pages 58 to 63 of Mr. Rothschild's direct testimony, Ex. DIV-5.

D. Revenue Decoupling Impacts on ROE

Mr. Rothschild determined that the cost of equity for National Grid would decrease by 75 basis points if the proposed revenue decoupling mechanism is implemented, as explained in his testimony, as follows:

> It would significantly reduce the non-diversifiable risks exposure to NG investors by a revenue stream that would be essentially unaffected by swings in economic conditions within the service territory. Consequently, the risk faced by NG's investors would begin to take on the essential characteristics of low-risk securitized debt.[36]

The testimony was essentially unrebutted in the record. In fact, National Grid's witness bolstered the Division's downward adjustment by specifically conceding that the business enterprise risk not only decreased significantly with the deployment of decoupling, but would actually approach "zero." Consider the testimony of witness Nick Stavropolous, Executive Vice President for NGrid's US gas distribution operations, who also appeared to be versed in cost of capital/investor risk analysis:[37] "[W]e have low demand exposure <u>heading towards zero</u> as new rate case filings include demand <u>decoupling</u>."[38] The evidence indicates that a 75 basis point reduction off of the Commission's selected ROE may not be sufficient in terms of capturing the level of risk reduction that flows from the adoption of "full decoupling."

[36] Page 37, lines 15-18 of Mr. Rothschild's testimony

[37] Mr. Stavropolous, while not a cost of capital expert, had actually previously performed "discounted cash flow" analyses used to calculate ROEs. October 22, 2008 Transcript, at 67.

[38] October 22, 2008 Transcript, at 76 (Emphasis supplied).

While NGrid witness Hevert recommends no reduction in the allowed return on equity as a result of implementing a revenue decoupling mechanism,[39] the basis for his position was an analysis that examined other regulated gas utility companies that had implemented various forms of revenue decoupling mechanisms. In conducting his analysis, he compared market to book ratios and stock price volatility before and after the implementation of the decoupling mechanisms. During Mr. Hevert's cross-examination, it became apparent that his analysis had so many flaws that it was useless. The most serious flaws are listed below:

1) The analysis did not consider if the other decoupling mechanisms in his comparative group applied to higher risk industrial customers or not.[40]

2) Many of the companies in the analysis implemented their respective plans in phases executed in different states. Therefore, whatever impact the decoupling clauses might have had on stock price would have been substantially diluted, making it impossible to compare a pre- and post-implementation cost of equity that forms the basis of conclusions.[41]

3) The analysis was not precise enough to consider the important distinctions between date filed, decision date, or the date the respective orders went into effect, when, in fact, Mr. Hevert even agreed that investors start placing probabilities as to the chance a decoupling plan would be put into place well before the date of decision.[42]

[39] Page 4, lines 6-7 of Mr. Hevert's direct testimony
[40] September 10, 2008 Transcript at 108-109.
[41] September 10, 2008 Transcript at 116-117.
[42] September 10, 2008 Transcript at 117-123.

4) The analysis uses Value Line's published beta figures even though they are calculated based on a trailing 5 year time frame – far too long of a period to recognize any changes in the cost of equity over the 180 day measurement periods he used in his analysis.[43]

E. Cost of Capital Conclusion

The Division's recommended cost of capital in this case is a reasonable, well-researched and well thought out result that deserves to be adopted by the Commission. It is supported by not only a DCF method that relies on the b x r approach that has been favored by this Commission in the past, but is similarly supported by a technically solid approach to the risk premium/CAPM method. Even NGrid Witness Moul's DCF method result of 9.84%[44] supports the Division's cost of equity recommendation of 9.95%.[45] It is only Mr. Moul's highly flawed Risk Premium, CAPM and Comparable Earnings Approach methods that arrive at an unjustifiably high alternative result.

Given the Company's own admission that National Grid is a "low risk" company, or even an "extraordinarily low risk" company, it would be irresponsible and unnecessary to award a return on equity that exceeds the lowest, reasonable level supported by the evidence – which clearly represents the Division's recommendation. The State's ratepayers and the heightened economic crisis facing

[43] September 9, 2008 Transcript at 130-131.
[44] Direct testimony of Paul Moul, at 46, lines 11-12.
[45] The 9.95% cost of equity result is based on a common equity ratio of 37.77% while Mr. Moul's recommendation is based on a lower risk capital structure of 47.71% (see NG-PRM-11 of Mr. Moul's Direct Testimony).

Rhode Island,[46] strongly militate in favor of this Commission exercising every bit of discretion to keep rates as low as possible. As a matter of law, the evidence in this case contains no qualitative basis for rejecting or even modifying Mr. Rothschild's recommendation.[47] In fact, the weight of the evidence supports the opposite conclusion: the DCF analysis, the underlying inputs, and the result are soundly grounded both in financial facts and principles.

In terms of capital structure, the Division's recommendation should be adopted because it represents the capital structure that the company <u>actually</u> uses to raise funds. The common equity ratio of National Grid, PLC is clearly reasonable because the bond rating for the holding company (a critical indicator of a company's financial health) is a robust "A-" and can be expected to be maintained.

If the proposed revenue decoupling mechanism is implemented, then it is appropriate for the Commission to reduce the allowed return on equity by 0.75% as recommended by the Division, since the Company's risk profile will undoubtedly decline rather significantly, as articulated in Mr. Rothschild's testimony.

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[46] During the evidentiary hearings, Wall Street experienced its worst week in the nation's history and economic reports placed Rhode Island on the top of the list for States having the highest unemployment rate – at 8.8 %.

[47] NGrid spent considerable time pointing out a mistake in Mr. Rothschild's Value Line analysis of comparable companies – but in the end, it had absolutely no impact on Mr. Rothschild's recommendations.

III. REVENUE REQUIREMENT

A. Rate Base

1. Projected Plant Additions

The evidence readily demonstrates that the Company is forecasting additions to plant in service of $36,679,000 in the twelve months ending September 30, 2008 and $60,780,000 in the twelve months ending September 30, 2009.[48] These forecasts, even exclusive of the effect of new programs such as the ARP, exceed the level of additions to plant in service in recent years and also the rate of actual additions to plant in service since the end of the test year. Accordingly, the Company's forecast of additions to plant in service subsequent to the end of the test year must be modified.

Based on the Company's actual rate of plant additions from the end of the test year through March 2008, the Division proposes to reduce the Company's forecast of plant additions for the twelve months ending September 30, 2008 by $5,282,000 and to reduce the Company's forecast of plant additions for the twelve months ending September 30, 2009 by $9,954,000.[49] The Division's proposed adjustments to the Company's forecast of plant additions have the effect of reducing the plant in service included in the rate year rate base by $10,259,000.

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[48] Exhibit NGRID-4, Attachment NG-MDL-1.

[49] As the rate year rate base reflects the forecasted average balance of plant in service for the twelve months ending September 30, 2009, the latter adjustment to forecasted 2009 plant additions reduces the rate year rate base by one-half of the amount of the adjustment, or $4,977,000.

As the pro forma rate year depreciation expense is calculated by applying the composite depreciation rate to the average balance of rate year plant, this proposed adjustment to plant in service also reduces the pro forma depreciation expense by $347,000 and reduces the balance of accumulated depreciation deducted from plant in service in the determination of rate base by $279,000.

The Company did not present any rebuttal to the Division's proposed adjustment in its rebuttal testimony, other than a general statement that it does not agree with the Division's proposed adjustments to the Company's forecasted capital plan. Moreover, late-filed discovery responses[50] demonstrated that the actual rate of capital additions subsequent to March 2008 has continued to fall well short of the Company's forecasts. The Company has offered no substantiation of its forecast of post-test year plant additions, and accordingly, the Division's proposed modifications to that forecast should be adopted.

B. Expenses

1. Medical and Dental Expense

In direct testimony, the Division proposed to reduce the Company's pro forma medical and dental expense by $907,000. In rebuttal testimony, the Company, in effect, agreed that its projection of rate year medical and dental expense might be too high, but to the extent that rate year medical and dental

[50] See NGrid's response to Division Data Request 13-4, Exhibit DIV-52.

expense should be adjusted downward, any such downward adjustment should be offset by an accrual for FAS 112 expense that had been erroneously omitted from its direct case. During the hearings, NGrid witness LaFlamme acknowledged that FAS accrual presented in his rebuttal testimony was overstated by $170,000.[51] In summary, the Company has agreed to $170,000 of the adjustment proposed by the Division. On review of documentation submitted by the Company, it appears that the Company's position on this issue is not unreasonable.

2. Gas Marketing Expense

National Grid has proposed a $1.377 million ratemaking adjustment for the costs of its proposed Gas Marketing Program ("GMP"). It has also asserted that the GMP is necessary for the Company to achieve additions to load that it has forecasted for the rate year period. The Division strongly contests the need for, and appropriateness of, ratepayer funding of this activity. Moreover, the record of this proceeding demonstrates that the Company's projections of forecasted increases in customers and load have already been achieved and are NOT dependent upon ratepayer funding of further marketing activity. The Division has also raised substantial concerns regarding key elements of the Company's gas marketing plan suggesting that they are:

[51] September 8, 2008 Transcript, at 91.

a. Distortive of, and potentially injurious to, existing competitive market structures;

b. Misleading in elements of the information offered to potential customers; and

c. Inappropriately expose utility to risks that are not necessary elements of regulated utility service, but are subject to the direct influence and control of the Company, its employees, its contractors and its Alliance Partners.

The Division also submits that the Company's claims that its costs of adding new customers exceed its expected incremental revenue are unfounded. As Division witness Oliver noted in his direct testimony and further discussed when he took the stand on October 21, 2008, the Company has focused its marketing program on adding customers for whom no additions to distribution mains are necessary. Thus, NGrid can add targeted customers at costs significantly below the average costs upon which its rates will be based. Since distribution mains represent **by far** the largest single element of the Company's rate base and the Company's largest element of its distribution operating expense, the avoidance of such costs means that as NGrid adds new customers it will also add to its profitability.

The evidence in the record demonstrates that the Company's gas marketing program is not well-conceived and is simply not necessary, at least in terms of having to increase customer rates in order to finance the program. The proposed program costs far exceed the amounts that area oil dealers seek to spend. On that basis, National Grid should be permitted to include in its revenue requirements only an amount equal to the planned spending of RI oil dealers, or $148,000, and the remainder of the $1,377,000 of gas marketing program costs should be eliminated.[52] Therefore, pro forma test year operation and maintenance expenses should be reduced by $1,229,000.

The incremental rate year sales that the Company has estimated will be produced by the gas marketing programs should <u>not</u> be eliminated since it is not unreasonable to expect that such growth in sales will be achieved even in the absence of the programs described by the Company. The response to Commission Data Request 3-8 illustrates the growth in conversions to gas heat even in the absence of the Company's gas marketing program.[53] Through the first eight months of calendar year 2008, there were 1,617 conversions and upgrades, an increase of nearly 250% over the conversions and upgrades in the corresponding period in 2007. In fact, the conversions and upgrades in the first eight months of calendar year 2008 exceeded the *annual* conversions that the gas marketing program seeks to achieve, as shown on Attachment NG-SPM-1. The expense of the Company's gas marketing program is unnecessary and should not be included in its cost of service.[54]

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[52] Direct testimony of Bruce Oliver, at 27, Exhibit DIV-3.
[53] Exhibit DIV-11.
[54] In his rebuttal testimony, Company witness Czekanski stated that certain adjustments to sales, revenues, expenses and rate base would be necessary if the Commission did not include the gas marketing costs in the Company's

In rejecting the gas marketing program, the Commission should also take into account the evidence demonstrating that the gas marketing program is another "win-win" strategy driven more by the interests of the Company and its shareholders, rather than ratepayers. First, the testimony made it clear that NGrid launched the gas marketing program earlier this year, which means that the costs of the program are currently being funded out of shareholder funds since the amounts have never been authorized in rates.[55] That fact alone is a compelling indication that the program not only began without Commission approval or rate recovery, but will likely continue without explicit cost recovery in the rates set by the Commission in this case.[56]

Second, the fact that the activation of the unregulated activities of National Grid Energy Services coincided with the launching of the gas marketing program appears to be more than an "uncanny coincidence."[57] Although the evidence suggests that only NGrid CEO Steve Holliday actually "knows" why these two programs are being launched simultaneously in Rhode Island,[58] Mr. Holliday's recent presentation to investors should leave no doubt that National Grid's "priorities are driven by a very clear view of where are the value opportunities in

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revenue requirement. Exhibit NGRID-16, at 23. However, as noted in the response to Division Data Request 13-7 (Exhibit DIV-28), the net effect of eliminating the gas marketing expenses, associated revenue increase, and associated plant additions would be a reduction of $1,103,000 to the Company's calculated revenue deficiency, which is approximately the same as the Division's proposed reduction to O&M expenses.

[55] October 22, 2008 Transcript, at 60-61.

[56] October 20, 2008 Transcript, at 142.

[57] October 20, 2008 Transcript, at 145; October 22, 2008 Transcript, at 64.

[58] October 22, 2008 Transcript, at 60, 64.

the business."[59] NGrid witness Sean Mongan conceded this as well – that the regulated and unregulated sides of the company, although they may be doing independent activities, both are driven by an effort to increase profits at the holding company level.[60] Moreover, it became sufficiently clear during the hearings that the average person would never really be able to distinguish National Grid (the utility) from National Grid Energy Services (the unregulated affiliate). Thus, it is National Grid Energy Services that becomes the dominant beneficiary of marketing expenses being borne by the ratepayers, second only to National Grid, the utility.

All of this may be logical for National Grid, [61] but the real questions faced by the Commission are: Do other ratepayers really need an additional rate increase (to recover more than $1.2 million annually) during this time of economic crisis? Do existing ratepayers really need to fund new heating equipment for other customers and pay the cost of marketing that will clearly benefit NGrid's unregulated enterprise? Additionally, is it really appropriate to ask existing ratepayers to carry this increased rate burden while at the same time they are also being asked to fund a comparable amount for the creation of a low-income discount, which National Grid proposes but also seeks 100 % recovery from ratepayers? There probably couldn't be a worse time in history for the utility to

[59] Statement of NGrid CEO Steve Holliday, Exhibit DIV-71, at 3.
[60] Testimony of Sean Mongan, October 20, 2008 Transcript, at 146.
[61] At the holding company level (National Grid, PLC), it's definitely a "win-win" situation.

seek funding for such an unnecessary program – one that clearly benefits the company in terms of increased system growth and sales, increased opportunities for NGrid's unregulated business, and most of all enhancing the "value proposition" for shareholders. Lastly, and probably most importantly, the gas marketing program arguably violates state law in that it is specifically designed to promote the consumption of natural gas and thus the expenses cannot be included in rates as commanded by R.I.G.L § 39-2-1.2.[62]

For all the foregoing reasons, the gas marketing program expense should be rejected. If National Grid believes that the program should go forward, it should continue to be funded by the Company on a "below-the-line" basis as it has been done thus far, or alternatively National Grid Energy Services can take responsibility for the cost of the program.[63]

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[62] The Division incorporates by reference the legal arguments advanced by the Attorney General in his Post-Hearing Memorandum, wherein the Attorney General presents compelling arguments that ratepayer funding of the GMP violates State law.

[63] The record was replete with many other liabilities that ratepayers would shoulder as exemplified by the situation with Mr. Thomas J. Murphy, who appeared at the hearing on September 9, 2008 to offer public comment regarding his very negative experience with one of National Grid's "Value Plus Installers" of a gas-fired furnace in his home. Apparently, the VPI contractor installed the wrong size and type of furnace. In response to his publicly aired complaint, the Company replaced the equipment at a total cost of $4310.00. See response to Record Request DIV-12. If it was not discovered in this case, the cost of fixing Mr. Murphy's liability would never likely have been identifiable in next year's DAC filing for treatment on a "below-the-line" basis. Moreover, the "guarantee" to customers who convert from oil to gas — that they can reconvert to oil and get a new oil burner two years after the fact ***for whatever reason***, is simply unreasonable. The Division appreciates the Company's decision to treat this "guarantee" as a shareholder expense as represented by NGrid witness Mongan, but the Commission will have great difficulty sorting out such expenses due to the limitations associated with identifying such events and reporting them for regulatory purposes. See October 20, 2008 Transcript, at 160,

3. Encroachment Expense

In its rebuttal case, the Company accepted the Division's position on this issue, a reduction of $756,000 to pro forma test year operation and maintenance expense.[64]

4. Distribution maintenance

In its rebuttal case, the Company accepted the Division's position on this issue, resulting in a reduction of $539,000 to pro forma test year operation and maintenance expense.

5. National Grid/SU Synergy Savings

The Company's share of supposed synergies and the "costs to achieve" or "CTA" associated with the National Grid/Southern Union transaction should not be included in the Company's pro forma test year revenue requirement. The Company used an after-the-fact method that takes into account only selected changes in expenses in order to calculate achieved synergies. This is not to say that the Company intentionally contrived a method of measurement to show synergy savings when no such savings actually exist. However, when the method of measuring savings is determined after the transaction has taken place, it is not unlikely that the method selected from a number of possible different methods can produce outcomes that present the merger in the most favorable light. It is for that reason that NGrid's

[64] Testimony of Mike Laflamme, Exhibit NGRID-4.

method of measuring the savings should not be accepted for the purpose of measuring synergy savings from the National Grid/Southern Union transaction.[65]

The Commission has already adopted a method of measuring synergy savings achieved by the former New England Gas Company, which was formed by the consolidation of the former Providence Gas Company and the former Valley Gas Company as a result of those companies being acquired by Southern Union Company. The Commission's adopted method, which is substantially the same as the method used to measure synergies achieved by the merger of the former Blackstone Valley Electric Company and Newport Electric Company into Narragansett Electric Company, is replicated on Schedule DJE-4.1 of Division witness Effron's direct testimony.[66] The Division's method considers changes in the total cost of service, not just changes in selected expenses. This is the correct method for measuring achieved synergies and it should also be used to measure the synergies achieved by the National Grid/Southern Union transaction because: (1) it has already been approved for this Company; (2) it was already in existence prior to the transaction; and (3) it is a broad measure of changes in the cost of service.

If the method on Schedule DJE-4.1, rather than the method on Attachment NG-MDL-1, Page 20, is used to measure synergies achieved by the National Grid/Southern Union transaction, *there are <u>no</u> synergies.* Accordingly, the

[65] The Company's method is contained in Attachment NG-MDL-1, page 20, of Mr. Laflamme's direct testimony.
[66] Exhibit DIV-1.

Company's share of the synergies and the associated CTA should be eliminated from the Company's revenue requirement, resulting in a reduction of the Company's pro forma operation and maintenance expense by $1,299,000.

The Company complains that any fair calculation of the synergy savings from the National Grid/SU transaction should measure the change in expenses from the period immediately preceding the transaction, the twelve months ended June 30, 2006, to the annual expenses subsequent to the transaction. Arguably, a comparison of the post-transaction cost of service to an adjusted cost of service for the twelve months ended June 30, 2006 as the benchmark for measuring achieved savings could, in theory, be useful. However, use of expenses for the twelve months ended June 30, 2006 to establish a benchmark would itself, in practice, be problematic, as the expenses for that period were unusually high and might not be indicative of the reasonable, normal level of ongoing expenses necessary to operate the business. That is, the Commission has <u>never</u> approved the expenses incurred in twelve months ended June 30, 2006 as being normal, reasonable expenses that are recoverable in the Company's rates. Therefore, the Company should not be able to use a benchmark that may well include expenses that were excessive and unnecessary for the purpose of determining the achievement of synergy savings. Thus, the twelve months ended June 30, 2006 cannot serve as the period to establish a benchmark without first establishing that the expenses incurred in that period were all appropriate for inclusion in the cost of service.

6. Adjustment to Uncollectible Accounts for Low Income Discount

The Division and the Company stipulated to a downward adjustment of $150,000 to the Company's uncollectibles expense stemming from the introduction of a discounted rate for low-income residential customers. The Division believes that the stipulation recognizes the value of the low-income rate to the Company and its shareholders in terms of mitigating the level of uncollectibles expense from that class.

C. **Pension and PBOP Tracker Rate Mechanism**

National Grid has not established that the proposed pension and PBOP reconciliation is a necessary and appropriate mechanism to implement at this time. As a general matter, reconciliation mechanisms are contrary to sound ratemaking practice, as such mechanisms tend to either reduce or eliminate incentives to control costs that exist under traditional ratemaking practices. Exceptions have been made when the particular costs are subject to large year-to-year fluctuations that are substantially beyond the Company's influence and control, thus jeopardizing the Company's financial integrity. NGrid's pension and PBOP expenses simply do not fall into that category.

National Grid presents the reconciling mechanism as a means of addressing the volatility of pension and PBOP costs and mitigating potential financial concerns resulting from such volatility. However, the Company has not provided any measurement of the volatility of pension and PBOP costs or any measurement of how the magnitude of changes in these expenses relate to overall revenue requirements; nor has the Company compared the magnitude or volatility of pension and PBOP costs relative to other costs for which there is no adjustment mechanism.

In addition, the Company has not presented any data or analysis that establishes the potential for the volatility of the pension/PBOP expense to impair its financial integrity. Pension costs are accrued pursuant to Statement of Financial Accounting Standards 87 and PBOP expenses are accrued pursuant to Statement of Financial Accounting Standards 106. Both of these accounting standards require certain actuarial and financial assumptions. While it is true that changes in those assumptions can cause pension and PBOP expenses to fluctuate, just about all other expenses included in the Company's base rate cost of service are also subject to fluctuation. The Company has not adequately explained why pension and PBOP costs should be treated differently from these other expenses that go into the base rate revenue requirement.

The proposed mechanism is not necessary to achieve the Company's stated objectives of providing adequate funding to support the pension and PBOP obligations and ensuring that customers pay the amounts necessary to provide pension and PBOP benefits to employees. The funding for the pension and PBOP programs is provided by the inclusion of the accruals in the cost of service, regardless of whether those accruals are subject to reconciliation. That is, the Company gets the cash from customers to pay for these programs by including the expenses in the revenue requirement. The expense accruals are already calculated in a manner so as to provide adequate funding of the programs, even without any reconciliation mechanism. With regard to the second objective, the amounts to pay pension and PBOP benefits to employees come from the separate funds from those programs. The contributions to those funds come from the recovery of the expense accruals in rates. The Company has presented no evidence that the present method has resulted in inadequate funding of the pension and PBOP programs. In fact, the evidence demonstrates that the Company's pension program is 97 % funded – a fact that completely undermines any notion that the current method of traditional regulation poses any concern or risk to the Company in terms of its ability to control and manage this cost item.[67] Division witness Effron summarized the situation well during the hearings:

> The pensions and benefits are a fraction of what the gas costs are and the fluctuations as measured against the company equity . . . are miniscule compared to the cost of gas. It's just not an expense where

[67] September 8, 2008 Transcript, at 245. As explained by Mr. Effron: "The fact that it's 97 % funded means that they've funded what the liability's been. Whatever incentives or disincentives have been there traditionally, they've been adequate . . . ."

> the fluctuations are going to jeopardize the company's well-being. . . . [T]o the extent that there are steps the company can take to control those costs, having the reconciliation mechanism would mitigate or even eliminate those incentives.[68]

Speaking of traditional incentives that traditional regulation promotes, the record demonstrated that the Company did, in fact, engage in cost controls to reduce the pension expense by instituting a "defined contribution plan" for new employees and ending the more expensive "defined benefit" pension program. The details contained in the Company's response to Division data request 6-22 provide substantial evidence of the manner in which the Company has exerted considerable control over its pension and PBOP costs.[69] The question for the Commission is as follows: Would National Grid have taken such cost control measures if all costs during that time were automatically recovered in a fully reconciling rate mechanism labeled as a "pension tracker"?

Even if the Company could demonstrate that, absent the implementation of the proposed mechanism, the fluctuations in the pension and PBOP pose a significant risk, its proposal is incomplete. The Company does not presently have any pension and PBOP reconciliation mechanism in place, nor were any such mechanisms in place at the time of the last base rate case. Thus, to the extent the volatility of pension and PBOP expense causes financial risks, such risks are

[68] September 8, 2008 Transcript, at 222, 223.
[69] Exhibit DIV-15.

implicitly incorporated into the cost of common equity. If a reconciliation mechanism is approved, then such financial risks are transferred to the Company's customers, and the authorized return on common equity should be reduced to incorporate that reduced level of risk.

In summary, the Company has not established that the pension and PBOP expenses should be treated differently from the other expenses that go into its revenue requirement, or that such a mechanism is necessary to assure adequate funding of the pension and PBOP programs. The pension and PBOP reconciliation mechanism proposed by the Company should not be approved by the Commission.

D. Three-Year Rate Plan Proposal

The Commission should not approve the alternative three-year rate plan proposed by the Company. First, the Division is proposing a substantial reduction to the initial rate increase being requested by the Company. To the extent that the rate increase is reduced, the effect of mitigating that rate increase by phasing it in over three years is of less benefit.

Second, the three-year rate plan is based on a projection of the revenue requirements in the rate year plus the two following years. It is difficult enough to forecast the revenue requirement for the rate year, much less the two years after the rate year. It is not possible to project the Company's revenue requirements in the twelve months ending September 30, 2012 with any reasonable degree of certainty to the extent that such projections can be used to establish rates going into effect in 2008.

Third, as a practical matter, the three year rate plan works only if the Commission accepts the Company's calculation of its rate year revenue deficiency exactly as presented, which would be highly unusual. If the Commission were to modify any elements of the Company's calculated revenue deficiency, then ancillary issues would arise as to how such modifications should be incorporated into the projections of the revenue requirements in the two years following the rate year, or if they should be incorporated at all. These practical considerations would make the three-year rate plan extremely difficult, if not impossible, to implement.

Over its proposed term, the Company's alternative three year rate plan, with the three annual rate increases, would, on a cumulative basis, provide it with approximately $23 million of revenues in excess of the revenues produced by its requested one time increase of $20 million (excluding the effect of any ARP rate adjustments). Obviously, such a plan is not beneficial to customers.

The Company provided no rebuttal to the Division's testimony on the proposed three-year rate plan. Based on the un-rebutted testimony of the Division, the Commission should reject the three-year rate plan.

E. APR Program and Tracker Rate Mechanism

National Grid is proposing to accelerate the replacement of bare steel and cast iron mains and high pressure bare steel services and is requesting authorization to implement annual rate adjustments for the revenue requirement effect of the capital additions related to this program to the extent that the additions exceed the amounts included in the rate year rate base. The rate adjustments would include the effect of the return on cumulative incremental investment, incremental depreciation, and property taxes.

The Division believes that the evidence supports implementation of the APR Program at this time. The past deficiencies in system maintenance and the documented growth in leaks[70] as compared to other jurisdictions justifies the APR Program as a means of advancing public safety by supporting the Company's ability to accelerate costly upgrades to the distribution system, particularly in urban areas where the age of bare steel and cast iron mains are more than a century old.[71] However, the Division proposed several modifications to the mechanism proposed by the Company, which are enumerated below:

- Reductions to depreciation expense related to associated plant retirements should be recognized.

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[70] For instance, the evidence showed that the leakage rates in Rhode Island were more than seven times higher thatn Upstate New York. Tr. 9/9/08, at 73.

[71] See generally, testimony of Susan Fleck and Don Ledversis, September 9, 2008 Transcript.

- The specific depreciation rates on the mains and services, rather than the average composite rate, should be used to calculate the incremental depreciation expense.

- The method of calculating the incremental property tax expense should be modified.

- The mechanism should apply only to the program to accelerate the replacement of mains and services but not to routine replacements.

- There should be no rate adjustment if the Company is earning at or above its authorized return on equity.

The Company agreed to all of these modifications,[72] and accordingly, the Division recommends that the Company's APR Program, and APR rate mechanism, as modified, be approved by the Commission.

IV. RATE DESIGN RECOMMENDATIONS

A. Non-Firm Rate Design Issues

1. Revenue Requirement Impacts Of Non-Firm Rate Design

On November 5, 2008, the Division entered into a Joint Stipulation with NGrid to provide the Company a mechanism for ensuring that the Commission's final determination on non-firm rate design issues in this proceeding, regardless of the nature of that decision, will not adversely affect the Company's revenues. That stipulation, however, does not resolve issues associated with the pricing of non-firm service that have garnered considerable attention in this case.

[72] Rebuttal testimony of Mike Laflamme, at 17-18, Exhibit NGrid 4.

2. *Sharing of Non-Firm Revenue Margins with the Company*

Under the current rate scheme, the Company has been allowed to retain 25% of the margins associated with Non-Firm Sales ("NFS") Service to the extent that total revenues exceed the threshold of $1.6 million that is embedded in base rates. As the evidence undeniably demonstrates, whatever historic basis existed to allow the Company to share in the revenues received from NFS customers above the $1.6 million threshold, that basis no longer exists today. The Company's sharing of margins was originally driven by a need to encourage the Company to maximize revenues from NFS customers in the face of real competition from alternative fuels.[73] As a result of industry restructuring, the opening of access to interstate natural gas pipelines, and an effective decoupling of market prices for natural gas and fuel oil alternatives, the premise behind "value of service pricing" and the justification for the Company sharing in "margins" has been substantially eliminated.[74]

To date, the Company has reaped substantial "below-the-line" profits for doing little more than applying a set formula for determining the rates for NFS service. Yet, the Company's retention of such margin revenue has no demonstrable effect on its pricing of non-firm service. Nor can it have such effects

[73] Direct testimony of Bruce Oliver, Ex. DIV-3, at 62-63.
[74] Direct testimony of Bruce Oliver, Ex. DIV-3, at 51.

since the Company's determination of prices is dictated by the provisions of the non-firm rate schedules set forth in the Company's tariff. Where incentives have no practical impacts on the Company's behavior, continuation of such incentives cannot be justified. The evidence also clearly demonstrates that the behavior of non-firm customers is driven solely by the marketplace and not by anything that the Company does in terms of administering the non-firm service rate schedules.

Equally important in considering the appropriateness of the Company continuing receipt of incentives is the fact that Firm-ratepayers – and not the Company's shareholders – absorb all of the risks associated with any shortfall in revenue below the $1.6 million threshold for margin sharing. It is neither reasonable nor equitable for the Company to retain 25% of non-firm margins above the $1.6 million level while Firm customers absorb all of the risk of revenue shortfalls below that level. NGrid must not be permitted to continue to reap substantial windfalls at the expense of its Firm service ratepayers. As recommended by Mr. Oliver, "the time has come for the commission to terminate the Company's sharing of margins derived from interruptible service customers."[75] The Division also notes that: (1) Mr. Oliver's testimony regarding the termination of margin sharing remains unrebutted in the record of this proceeding; and (2) the record contains no evidence whatsoever to justify incentive payments on a going-

[75] Direct testimony of Bruce Oliver, Ex. DIV-3, at 64.

forward basis. Accordingly, the Division submits that the continued sharing of non-firm revenue margins by the Company can no longer be justified and must be terminated. The Division also emphasizes that its position regarding the termination of the Company's margin sharing is the same regardless of whether value of service pricing is continued or fixed rates for non-firm service are established.

3. Flexible Firm Service Proposal

The Company in this proceeding proposes the reintroduction of a "flexible firm service" rate. The Division, through the testimony of Mr. Oliver, enumerates five problems associated with the Company's proposed reintroduction of the service, and recommends against the adoption of that proposal.[76] NGrid offered no rebuttal to the Division's case on these issues and conducted no cross-examination of Mr. Oliver regarding his position on the flexible firm service proposal. Thus, the Division submits that the record of this proceeding does not support Commission approval of NGrid's proposal to reintroduce flexible firm service.

B. Inadequacies in Class Cost of Service Study

The record in this case demonstrates that there was a lack of detailed information to support the Company's Class Cost of Service results. This fact was borne out by the Company witness Heintz during his testimony as well as

[76] Direct testimony of Bruce Oliver, Ex. DIV-3, at 62-62.

numerous responses to Division data requests, which consistently contain language along the following lines:

> *The Company does not track, record or otherwise separate costs of administration and billing of individual services and therefore has not developed any estimate of the costs of administration/billing/meters, etc. . . .*[77]

Some of the constraints on data availability can be attributed to the fact that NGrid's predecessors did not maintain the data or transfer it to NGgrid during the mergers. However, the frequency of responses that data necessary to properly assess class cost responsibilities was either "***unavailable***" or that "***The Company does not track, record or otherwise separate*** …"[78] various types of costs by class of service or by activity (i.e., transportation service versus sales service) is somewhat alarming. Moreover, the record shows that Company's use of "*replacement cost*" information to determine class allocations of services is not even based on Rhode Island data, but rather information for NGrid operations in other jurisdictions. Further, the "*replacement cost*" data that the Company relied upon only distinguished "*replacement costs*" for Residential and Commercial customers. No differences in costs for the varying sizes and types of C&I customers for which NGrid offers separate pricing in Rhode Island were reflected in the "*replacement cost*" data the Company used – despite the existence of

[77] See Transcript of October, 20, 2008, at 24-50.

[78] See for example NGrid's responses to Division Data Requests DIV 5-22, DIV 5-31.b, DIV 5-39, DIV 5-40, DIV 5-45, and DIV 5-46.

substantial differences in the magnitudes of non-residential customers' service requirements. Likewise, no effort was made to assess differences in service line investment costs for Residential Heating and Residential Non-Heating customers.

As witness Oliver stated in his concluding remarks regarding the Company's class cost of service study in his direct testimony:

> *The precision and reliability of class cost allocation results can only be as good as the data that is used in the development of the study. The identification of cost allocation methods to be used and the mechanical application of those methods only reflect a portion of a cost analyst's responsibilities. Investigation of the relationships that lie behind the incurrence of costs and the development of cost allocation factors that are reflective of actual cost relationships are just as important as the choice of allocation methodology to be employed.* [79]

Based on the foregoing, the Division submits that the Commission should require NGrid to develop a plan for improving the class sensitivity of data available for the performance of class cost of service analyses in future base rate proceedings. The Commission should also require that such plan be submitted for

[79] The Direct Testimony of Division witness Oliver at pages 38-39. Mr. Oliver elaborated on the collateral effects:

> *This is a particular concern in the allocation of customer-related elements of the Company's costs of service. Only rarely are customer-related costs actually incurred on a uniform (i.e., equal dollars per customer) basis for all customer classes, or even for all non-residential classes. Efforts to streamline the preparation of class cost of service studies, however, often lead to the use of simplifying assumptions that improperly treat broad groupings of customers as being homogeneous in terms of their responsibilities for customer-related cost elements. As a result, differences in customer-related cost responsibilities among rate classes can be blurred. Moreover, such blurring of class cost responsibilities is typically reflected in the customer cost analyses that utilities such as National Grid rely upon in the establishment of customer charges by rate class.* Id.

review by the Commission and the Division within 90 days of the issuance of the Commission's final order in this case.[80]

C. Firm Service Rate Design Considerations

While the Company seeks an overall increase in distribution revenue of 15.95%, the proposed increases in customer and demand charges for most classes range from 46.7% to over 114%, or roughly three to seven times the overall average increase that National Grid requests.[81] The magnitude of the increases is rather extreme and simply fails to comport with the Commission's longstanding policy of providing for "rate continuity and gradualism." In order to protect customers, the Commission should adopt the Division's recommendation that no class receive an increase in its monthly customer and demand charges that exceeds the greater of 33% or the class average increase.[82] Second, the remainder of the increase for each class should be spread proportionately over all usage for the class.[83]

D. Reconciliation of Uncollectible Accounts Expenses ("UAE")

NGrid has proposed in this proceeding that the methodologies for both its GRC and DAC rate adjustment calculations be modified to provide for annual

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[80] In this case, the results of the Class Cost of Service Study are imprecise and thus weaken the Commission's ability to rely on the Study results. In future cases, this deficiency can be overcome by requiring the Company to employ statistical sampling techniques and better tracking of costs incurred by each rate class, which can be accomplished with minimal resources and at minimal cost. Direct testimony of Bruce Oliver, Ex. DIV-3, at 36.

[81] Direct testimony of Bruce Oliver, Ex. DIV-3, at 45.

[82] Direct testimony of Bruce Oliver, Ex. DIV-3, at 46.

[83] *Id.*

reconciliation of the Company's actual Uncollectible Accounts Expenses ("UAE"). The Division does not support the Company's proposal because it would add to the volatility of both DAC and GCR adjustments and is inconsistent with this Commission's objective of improving the stability of rates.[84] The known frequency of significant year-to-year fluctuations in the Company's actual UAE experience has historically led this Commission to use a multi-year average of the Company's actual experience in base rates as a way of mitigating the year-to-year variations. NGrid's proposed annual reconciliation proposal for UAE expenses would totally reverse that long-standing policy which the Division has consistently supported and continues to support. Therefore, the Division urges the Commission to reject NGrid's efforts to include annual reconciliations of UAE expenses in its DAC and GCR mechanisms.

V. REVENUE DECOUPLING

To begin with, the concept of "full revenue" decoupling has not been around long. The record is clear that only a limited number of jurisdictions have approved some form of revenue decoupling, and within those jurisdictions, the Commissions have only employed decoupling for a limited number of utilities. These efforts have occurred mostly during the past two years, and at this point, there is very little evidence available in terms of actual impacts on ratepayers and the overall success

[84] Direct Testimony of Bruce Oliver, Exhibit DIV-3, at 74-75.

in removing "disincentives" to pursue energy conservation programs, particularly for the gas industry. In fact, if this Commission approves National Grid's decoupling proposal, not only would it mark the first decoupling within the Company's US operations, it would also constitute the first approval of decoupling for a gas distribution utility in the entire New England region.[85]

<u>The Real Beneficiaries of Decoupling: NGrid's Shareholders</u>

The overall record in this proceeding presents a rather lackluster presentation about the real need for revenue decoupling as a ratemaking policy matter. After days and days of hearings, the record is extremely murky concerning what opportunities really exist for deploying "ramped up" demand side management ("DSM") programs. In fact, there was no evidence about what National Grid is actually going to accomplish in the area of increased energy conservation that it could not already do under the long-term, sustained pace of existing DSM programs.[86] Those existing programs have been pursued by National Grid with the approval of the Commission (and financed entirely with ratepayer money) for more than 20 years in Rhode Island with remarkable or even "phenomenal" success according to National Grid's own statements to this Commission.[87] On the electric side, National Grid has systematically touted its

[85] Transcript 9/26/08, at 145-46.
[86] When Ngrid witness James Simpson was asked on redirect about his knowledge of "ramped up" conservation programs in other jurisdictions that had adopted decoupling, he knew of none! See September 26, 2008 Tr., at 232.
[87] In re: Narragansett Electric Company, Conservation and Load Management, Order No. 13691 in Docket 2930.

success in deploying these programs and has fought to prevent the programs from being administered by neutral third parties, who were thought to not face the "disincentives" that now appear to haunt National Grid, or at least the Company's environmental partners. Regardless of whether the Commission approves decoupling, National Grid represents that it will pursue the "ramp up" of DSM programs.[88] Consider the following excerpts from prior Commission orders documenting the efforts and commitment of National Grid's predecessors in the area of conservation:

- "[Narragansett] testified that the programs are nationally recognized."[89]
- "The impetus to maximize C&LM is created through incentive payments . . ."[90]
- "[T]he performance levels . . . exceed historical performance . . ."[91]
- "The C&LM approach submitted in this docket is innovative, comprehensive, and bold in its expectations of reducing energy consumption . . ."[92]
- "Narragansett has advanced a worthy objective."[93]
- "Narragansett detailed the phenomenal success of EI . . ."[94]
- "Narragansett has been a leader . . ."[95]
- "We [Narragansett] practice what we preach."[96]
- "We find the Company's plans to be entirely consistent with our national energy goals . . ."[97]

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[88] See testimony of James Simpson, Tr. 9/26/08, at 141-42.
[89] Docket No. 3463, Order No. 17516, at 3.
[90] Docket No. 1939, Order No. 13281, at 6.
[91] Docket No. 3463, Order No. 17516, at 21.
[92] Docket No. 1939, Order No. 13281, at 8.
[93] Docket No. 1939, Order No. 13281, at 8.
[94] Docket No. 1939, Order No. 13691, at 1.
[95] Docket No. 1499, Order No. 10299, at 73.
[96] Docket No. 1499, Order No. 10299, at 73.

The Commission's prior orders are replete with statements about the commitment of the utility's management in fulfilling the noble cause of conservation, executing cost-effective and innovative programs, and then receiving a special "incentive" that boosted the Company's reported earnings. If history is any indication, National Grid, both as the owner and operator of the State's only gas utility, should be more than capable of maintaining or exceeding the longstanding commitment of its predecessor companies, particularly now that the Company has embraced climate change and carbon reduction as one of its core corporate missions.[98]

Moreover, all of those conservation programs were deployed along with a systematic adjustment to the "rate year billing determinants" to reflect the forecasted reduction of revenues that was projected to occur as a result of planned conservation efforts. In fact, the record in this case makes it extremely clear that both the Company's existing rates and the proposed rates for the "rate year" specifically reflect effects of decreased consumption stemming from conservation programs and the overall national/regional/local trends that continue forecasting declines in consumption.[99] It remains curious that the Company decided to launch

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[97] *Id.*

[98] Both Mr. Simpson and Mr. Stavropolous in particular discussed the importance of environmental issues to National Grid's corporate philosophy.

[99] See testimony of James Simpson, Tr. 9/12/08, at 144-45; see also testimony of Nick Stavropolous, 10/22/08, at 38.

its gas marketing program earlier this year (at the expense of its shareholders) but in stark contrast, the Company appears to be awaiting the outcome of this case before it makes the full commitment to do what the Commission has already ordered and what the law currently mandates.

The evidence makes it clear that National Grid is making Rhode Island its experimental starting point for deploying its preferred form of revenue per customer ("RPC") decoupling. National Grid has yet to gain approval of RPC decoupling in any other jurisdiction. Just like with electric deregulation, the place to start always seems to be in Rhode Island.[100] The Division believes that the RPC decoupling mechanism is not only unnecessary at this time, but more importantly, the mechanism is clearly biased in favor of the Company. The RPC mechanism offers the Company complete insulation against the effects of variation in usage on distribution revenue. The mechanism divorces the Company's performance from revenues and shifts tremendous responsibility to the Commission to ensure that the system and service quality are maintained at appropriate levels. The significant benefit to the Company and its shareholders of obtaining decoupling is rather undisputed: it essentially would reduce the Company's revenue risk to "zero" – a corporate strategy that is clear from National Grid's "Investor Day" presentation.[101] Unlike many other jurisdictions where some form of decoupling was approved in

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[100] Rhode Island was the first State in the nation to enact comprehensive restructuring legislation for the electric industry. The effects are still being felt today.
[101] Exhibit DIV-69, slide 6, attached to the Brief as Attachment B.

the context of a settlement that offered concrete benefits to ratepayers,[102] here the Company wants the benefit of decoupling without offering ratepayers anything except a future commitment to "reach for the stars"[103] in terms of pursuing more aggressive conservation efforts.

Moreover, any revenue erosion impacts from DSM programs are already reflected in the proposed revenue requirement in this case in that the "assumed reduction in use per customer" from the conservation efforts are reflected in the rate year billing determinants.[104] Under this long-established ratemaking procedure, there is simply no material impact on the Company's "opportunity to earn a fair rate of return."[105]

The only evidence in the case that suggested that the Company's "opportunity to earn a fair rate of return" was undermined came during the cross-examination of James Simpson, the architect of the RPC decoupling mechanism. It had nothing to do with conservation. He explained that the Company's current earnings situation was rooted in the "upheaval"[106] that is commonplace when utilities are engaged in merger activities, such as the National Grid/Southern Union

[102] Like the settlement Bruce Oliver agreed to support in Maryland – it offered $6 million in rate decreases to the customers he represented in that case, among other benefits. 10/23/08 Transcript, at 149. It should also be noted that the decoupling "benefits" apparently never came to fruition. Mr. Oliver explains: "As it turns out, we do not believe that the rate stability that the company had suggested has borne fruit. We're getting regular rate adjustments, and for many of the classes, they have been much more significant . . .". Id. Unlike in this case, at least Mr. Oliver's clients in the Maryland case received a substantial rate increase as a concession for allowing the company to benefit by the implementation of a revenue decoupling mechanism.
[103] Testimony of Nick Stavropolous, October 22, 2008, at 28, line 10.
[104] Tr. 9/12/08, at 144-45.
[105] Mr. Simpson made the contention. See September 12, 2008 Transcript, at 107, lines 3-8; 134, lines 19-20.
[106] Tr. 9/12/08, at 92, line 2.

merger and the National Grid/Keyspan merger.[107] Mr. Simpson explained that the mergers acted as a "very serious distraction to the company" that caused the management to forego the opportunity to seek rate relief even though the Company's earnings had fallen below it authorized ROE.[108] As he explained, "You got to run a public utility [or] you got to be focused on mergers and acquisitions."[109] Consider the exchange with Mr. Simpson:

> Q. [Y]ou acknowledged there was a revenue deficiency and the company failed to file a rate case?
>
> A. I believe its fair to say that the company made a management decision to allocate its resources to the integration with National Grid.
>
> Q. And let's make sure the record is clear. There was no prohibition of the company filing for a rate case earlier than it happed to do so in this case, correct?
>
> A. I'm not aware of any prohibition, that's correct.
>
> * * *
>
> Q. And these decisions where the company chose not to file a rate case occurred under the traditional regulation format?
>
> A. Yeah. . . .

Had there been a revenue decoupling mechanism in place since the last rate case determination in Docket 3401, the evidence indicates that National Grid would have received an <u>additional $34.1 million</u> over the four-year period.[110] Nevertheless, Mr. Simpson claims "revenue decoupling mechanisms are gaining

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[107] Tr. 9/12/08, at 92-96.
[108] This was the Company's claim, although it was never tested in a ratemaking forum.
[109] Tr. 9/12/08, at 95. As he further elaborated: "It would have been difficult, if not impossible, for the company to go in for a rate case proceeding until the dust had settled." Id., at 93.
[110] Response to TEC-RI 1-7; conceded by NGrid witness James Simpson at hearing on September 26, 2008, at 100, line 7.

acceptance" because there is a "real problem and revenue decoupling mechanisms are a real solution."[111] Yes, but a real problem for whom? Perhaps for the Company and its shareholders, but it is certainly not a problem for the ratepayers.

One of the principle reasons advanced for decoupling was the concern that traditional ratemaking procedures no longer allowed the Company to "invest in infrastructure replacements and improvements."[112] But that concern has now been <u>significantly mitigated</u> with the Company's Accelerated Pipeline Replacement Program and the proposed implementation a "capital tracker" rate mechanism that guarantees National Grid incremental revenues associated with those investments, thereby directly enhancing the Company's opportunity to "earn a fair rate of return under current conditions."[113] Thus, if this Commission approves the APR Program, a primary argument advanced by the Company no longer exists.

The record also reflects that National Grid's process of determining what classes should be subjected to the decoupling mechanism, and which classes should not be, was highly subjective and not guided by any defined criteria. When it first filed its proposal, the Company sought decoupling for all classes except new Extra Large Industrial customers. At the moment the hearings began, the Company attempted to withdraw the entire decoupling proposal on the theory that

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[111] September 12, 2008 transcript, at 109.
[112] Simpson Rebuttal testimony, at 10.
[113] Id. It should be noted that no party in the case objects to the APR Program.

decoupling was not well-received or even "misunderstood"[114] by the parties representing ratepayer interests, all of whom strongly objected to the Company's proposal.[115] Mid-stream in the hearing process, the Company amended its position to exempt all Large and Extra-Large Commercial and Industrial customers, and then later sought to exempt the Low-income Residential class. The Company's flip-flop approach to the application of full revenue decoupling, while clearly a strategic course to minimize opposition, still demonstrates the highly subjective and excessively discretionary approach to such an important paradigm shift in ratemaking.

The Division's Case Against Decoupling Is Compelling

As this Commission knows, the Division has long relied upon the assistance of Bruce Oliver in helping to articulate positions that advance the interests of ratepayers while at the same time treating the Company in a reasonable manner.[116] With regard to the decoupling proposal, Mr. Oliver expressed a number of compelling reasons as to why the approach was unnecessary and inappropriate at this time:

(1) The "disincentive" the Company faces is illusory since conservation is mandated by State law;[117]

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[114] See letter from Ron Gerwatowski to the Commission, dated September 3, 2008.
[115] NGrid proposed that decoupling be relegated to another proceeding after all parties had spent considerable resources to litigate the issue in this case.
[116] Mr. Oliver has assisted the Division and Commission for almost twenty years. He is a key architect of the Company's gas buying program that serves as a national model for securing low cost gas supplies and maintaining price stability.
[117] Tr. 10/25/08, at 178.

(2) Energy efficiency will be pursued by customers regardless of whether decoupling is adopted;[118]

(3) "Forceful" advocacy of energy conservation will not dramatically alter customers' energy usage;[119]

(4) The Company's rate structure already contains <u>four</u> forms of partial revenue decoupling mechanisms thus mitigating the effects of revenue erosion;[120]

(5) With the payment of incentives, conservation programs don't necessarily hurt the Company;[121]

(6) Decoupling produces inequitable results since customer usage within particular rate classes are not uniform;[122]

(7) Traditional regulation works – the Company exercises prudent cost management, which is a good thing;[123]

During the final day of hearings, Mr. Oliver summarized it in a nutshell:

> [T]here are many types of revenue decoupling, many types of mechanisms, several of which are already in place for this company . . . With all of those factors . . . guaranteeing a revenue requirement per customer to me is <u>really extreme</u>, it's unnecessary and it actually produces the adverse effect that as the company adds more customers [i.e., via the gas marketing program], they're increasing their profitability over time. I mean, it's great for the company because it gives them the expectation of greater growth in earnings if they can add more customers."[124]

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[118] Exhibit DIV-4, at 3.
[119] Exhibit DIV-4, at 4.
[120] The four forms of partial revenue decoupling are: (1) a weather normalization factor that adjust distribution revenue for the effects of winter weather on gas usage; (2) the addition of demand charges to the Company's rates for commercial and industrial customers; (3) declining block distribution charge structures for Small C&I and Residential Heating customers; and (4) the use of a future test year to reflect know reductions in consumption. See Direct testimony of Bruce Oliver, Exhibit DIV-3, at 5; and October 24, 2008 Transcript at 9-10.
[121] October 24, 2008 Transcript, at 10, lines 10-13.
[122] October 24, 2008 Transcript, at 11-12; see also Exhibit DIV-3, at 17-18.
[123] October 24, 2008 Transcript, at 17-18.
[124] October 24, 2008 Transcript, at 25.

Mr. Oliver's assessment of RPC decoupling, in terms of shareholder/ratepayer balance of interests, harkens back to the corporate strategy articulated in National Grid, PLC's "Investor Day" presentation: [125] "It gives them greater assurance of their revenue levels which makes that stock more attractive in the marketplace which would tend to lead to a relatively higher price for the stock and more . . . asset or stock appreciation in the process."[126] In terms of the ratepayers' interests, there is no foundational evidence upon which to provide such a valuable offering to shareholders, particularly in this time of economic crisis. On that basis, and for all of the other policy reasons advanced by Mr. Oliver and other parties, the Company's revenue decoupling proposal should be rejected.[127]

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[125] Exhibit DIV-69.

[126] October 24, 2008 Transcript, at 210.

[127] An important lingering concern about National Grid's current decoupling proposal is that the Company has not provided for continuation of Weather Normalization Adjustments (WNAs) for classes that it would exempt from "Full" revenue decoupling. The Company's current WNA mechanism is designed for application to all Firm Sales Service classes. Under the current WNA mechanism, deviations from normal winter heating degree days that exceed the dead band for adjustments (i.e., plus or minus one percent of normal heating degree days) are multiplied by a fixed revenue per degree day factor that was negotiated as part of the resolution of issues in Case No. 3401. The established revenue per degree-day factor was designed on a Company-wide basis for all Firm Sales Service classes, and no basis exists for determining comparable factors for individual classes that might be exempted from "Full" Revenue Decoupling. Thus, a decision by the Commission to accept NGrid's revenue decoupling proposal for certain classes while exempting others would leave the exempted classes with no operable mechanism for computing WNA adjustments for the exempted classes, even though some of the exempted customer groups (i.e., Large and Extra Large Low Load Factor C&I customers and Low Income Residential Heating customers) have noticeable weather sensitivity in their gas use.

The Company provided no discussion of this issue in any of its pre-filed testimony or during the oral testimony of witnesses. Rather, the first time NGrid raised any concern with respect to this matter was during the Company's cross-examination of Division witness Oliver near the close of hearings in this proceeding. In response to Company's questioning, Mr. Oliver pointed out the problems associated with any attempt to continue to apply the present WNA to classes exempted from the decoupling mechanism. As a result, the record of this case is devoid of any basis for establishing WNA adjustments for individual rate classes. Thus, if the Company's "Full" revenue decoupling proposal is approved, the only option available to the Commission is allow the Company to provide service to classes exempted from that mechanism without any WNA adjustments. Given the observable weather sensitivity of load for several of classes that NGrid proposes to exempt from "Full" Revenue Decoupling, the

VI. CONCLUSION

This case undeniably posed challenges to the Commission and the Division in terms of the magnitude and complexity of the issues presented in a single rate case venue. The Commission went to extraordinary lengths to allow for the development of a comprehensive record on every issue. The Division submits that its recommendations in this case are well thought out, reasonable, and soundly rooted in the evidentiary record. Given the supporting evidence, the Division urges the Commission to adopt the recommendations in this brief and to protect the interests of ratepayers.

Respectfully submitted,

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Dated: November 6, 2008

Division cannot support a resolution of these matters that would allow those classes to be subject to annual WNA adjustments. On the other hand, if the Commission rejects NGrid's "Full" Revenue Decoupling proposal, the Division believes that continued application of the current WNA mechanism within the DAC is reasonable.

CERTIFICATE OF SERVICE

I hereby certify that on this 6th day of November 2008, I served a true and accurate copy of the within *Post-Hearing Memorandum* electronically and by mailing a copy, first class, postage prepaid, to all parties listed on the Service List for Docket No. 3943, to them at their usual place of business as hereinabove set forth.

Kelly Zoglano

We are a very low risk business

Factor	Exposure	Notes
Inflation	Low	◆ UK asset base RPI indexed, some regulatory allowances above RPI ◆ Variety of protections under US rate agreements (index-linked rates and exogenous cost allowances) ◆ Some exposure to materials / contractor price inflation above RPI
Demand	Low ⬇ Zero	◆ No UK demand exposure ◆ Residual exposure under some US rate plans, diminishing risk as new rate case filings include demand decoupling
Commodity (energy)	Very low	◆ No commodity exposure under UK regulatory agreements ◆ US rate plans pass-through commodity costs to customers – timing variances on recoveries. Some residual exposure to the commodity element of bad debts
Currency	Very low	◆ $ earnings exposure minimised by natural debt hedge ◆ +/-10 cent move in the dollar ≈ +/-£20m move in earnings
Financing	Low	◆ Cash generative business: over £3bn operating cash flow per year ◆ 80% of net debt either fixed rate or index-linked ◆ No need to enter the markets again this financial year
Regulation	Low	◆ Multiple regulators: well placed to leverage best regulatory practices ◆ Portfolio of ~20 main regulatory agreements leads to greater stability in operating profit

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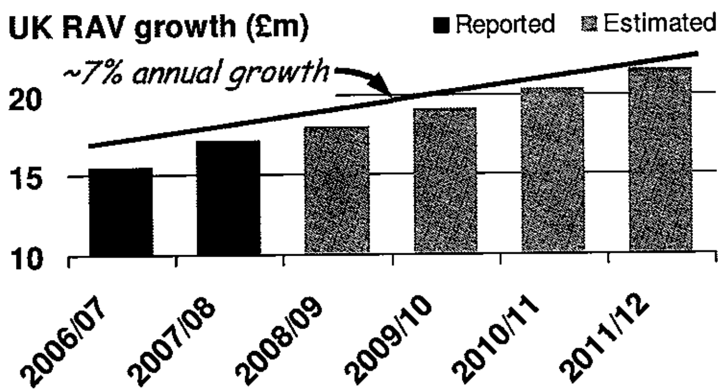
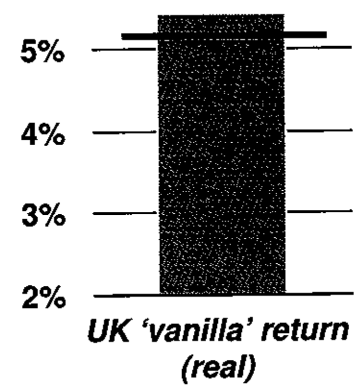
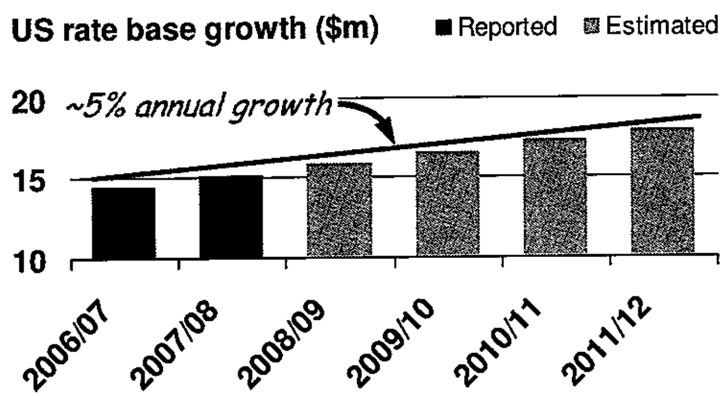
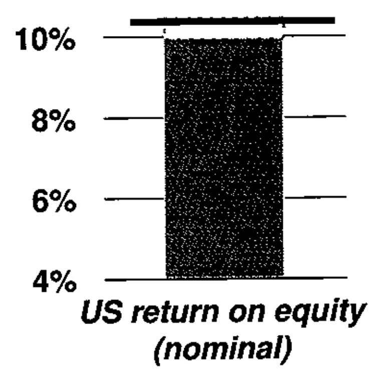
~£3bn annual investment, growing our asset base, with returns above our cost of capital









KEY:

Base regulatory allowed return

Actual reported return

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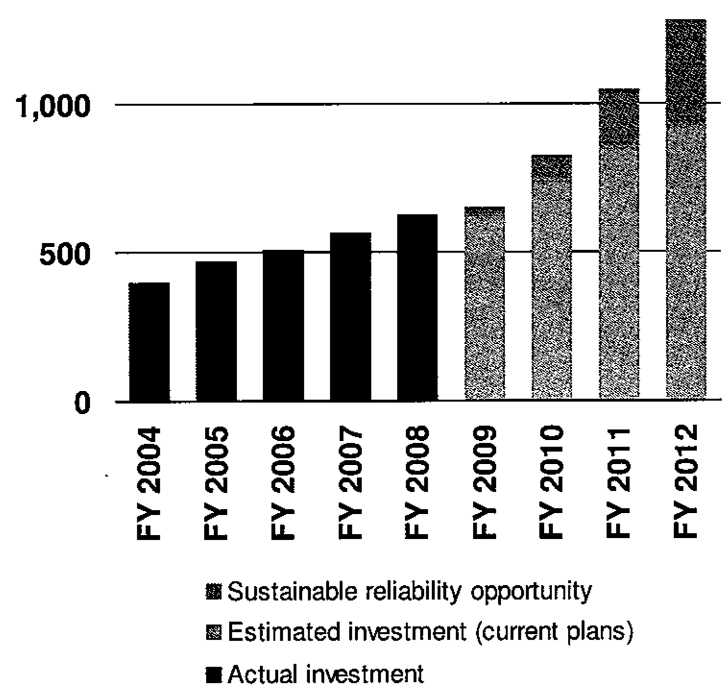
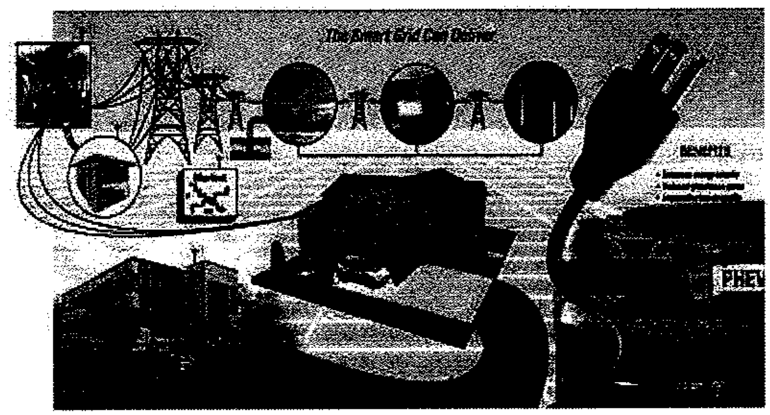
2006/07 rate base includes former KeySpan businesses that were acquired by National Grid on 24th August 2007.

A new level of discipline – investing only where we have recovery of investments in the rate base

Sustainable reliability opportunity ($m)*



Smart grid: opportunity for significant increases in investment



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* *Electricity Transmission & Distribution investment.*

US – main rate plans
Gas distribution

	Downstate New York	Long Island	Upstate New York	Boston (MA)	Essex (MA)	Colonial (MA)	Rhode Island	New Hampshire
Base ROE	9.8%	9.8%	10.6%	10.2%	11.2%	11.2%	11.3%	10.4%
Rate Base	$2,239m	$1,715m	$1,084m	$1,328m	$168m	$641m	$578m	$265m
Actual Return	14.9%	10.4%	N/A	7.4%	25.7%	12.7%	3.2%	4.9%
Sharing shareholders %	100% to 10.5% 50% to 12.5% 35% to 13.5%	100% to 10.5% 50% to 12.5% 35% to 13.5%	100% to 11.75% 50% to 14% 25% to 16% 10% above 16%	100% from 10.2 - 14.2% 75% from 10.2 - 14.2%	None	None	50% to 12.25% 25% above 12.25%	None

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