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November 10, 2008

Via Electronic Delivery and Regular Mail

Luly E. Massaro, Commission Clerk
Public Utilities Commission
89 Jefferson Boulevard
Warwick RI 02889-1046

In Re: National Grid – Request for Change in Gas Distribution Rates
Docket No. 3943

Dear Ms. Massaro:

Attached for filing, on behalf of the Division of Public Utilities and Carriers, is an original and nine copies of their Reply to Post-Hearing Memoranda.

Thank you for your attention to this matter.

Very truly yours,

Paul J. Roberti
Assistant Attorney General
Chief, Regulatory Unit

PJR/mt
Enclosures

cc: Thomas F. Ahern, Administrator
Service List

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

REPLY OF THE DIVISION OF PUBLIC UTILITIES AND CARRIERS TO POST-HEARING MEMORANDA

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Dated: November 10, 2008

I. COST OF CAPITAL

A. <u>Capital Structure</u>

The Company's claim that Division witness Rothschild somehow failed to follow GAAP accounting when computing the capital structure for National Grid, PLC must be recognized by this Commission for what it is: an unsupportable, erroneous criticism of Mr. Rothschild's capital structure computation. Mr. Rothschild properly used the GAAP accounting statements of National Grid, PLC when computing its actual capital structure. In contrast, Company Witness Moul basically invented his chosen methodology for computing the equity ratio by subtracting short-term investments from debt – a methodology that Mr. Rothschild had never before seen "proposed or adopted by a utility commission."[1]

Unlike the Company's witness, Mr. Rothschild followed GAAP when computing capital structure.[2] Moreover, had Mr. Rothschild followed the regulatory principles advanced by Mr. Moul instead of relying on GAAP, he would have arrived at a <u>lower common equity ratio</u> than he did, since regulatory principles do not allow "goodwill" to be added as an asset to rate base. In fact, the effect of writing off goodwill would be the same as subtracting goodwill from common equity, thereby lowering the computed common equity ratio. The

[1] Tr. 9/10/08, at 153.
[2] Tr. 9/10/08, at 152-69.

Company's arguments leave the Division's capital structure recommendation unscathed.

B. Cost of Equity and Capital Structure Consistency

In its Initial Brief, the Company claims that Mr. Rothschild was inconsistent because his proxy group has a different average capital structure than the capital structure of National Grid, PLC.[3] A review of Mr. Rothschild's direct testimony in this proceeding shows that Mr. Rothschild was consistent because he made a specific adjustment to increase his recommended cost of equity to account for the capital structure difference between National Grid, PLC and the proxy group. Thus, in Mr. Rothschild's direct testimony, he specifically recommends a 9.95% cost of equity with his recommended capital structure, and a 9.50% cost of equity if his recommended capital structure were not used.[4] JAR Schedule 2 specifically shows that the difference between the 9.95% and the 9.50% cost of equity is the "Allowance for risk of capital structure with 37.77% common equity instead of 49.12%."[5] JAR Schedule 7 shows that the 49.12% common equity ratio is the actual common equity ratio of the proxy group.

It is particularly strange that the Company criticizes Mr. Rothschild for being inconsistent because a close reading of the record shows the exact opposite to be the case. While Mr. Rothschild did allow for consistency by increasing the

[3] NGrid Brief, at 9-10.
[4] Exhibit DIV-5, at 4.
[5] Exhibit DIV-5, at 72.

cost of common equity to account for capital structure differences, when going the other way, Company Witness Moul failed to decrease his recommended cost of debt to reflect the cost of debt that National Grid, PLC would have been able to achieve if it had used the proxy group capital structure rather than its actual capital structure.[6] Similar to the issue of capital structure, the Division's ROE recommendation remains unscathed despite some rather unfair and inaccurate claims.

II. REVENUE REQUIREMENT

A. Rate Base Additions

In its initial Brief, the Company continues to claim that there was a "lag" in contractor billing, which, according to NGrid witness Fleck, caused capital spending to be slightly below forecasted amounts in the early months of the financial cycle, but that spending would ramp up by the end of the cycle.[7] Thus, National Grid claims that its proposed rate base is reasonable in terms of representing forecasted capital additions.[8] Despite its claim, the Company still has *not* provided a full and complete answer to the concerns advanced by Division witness Effron. Simply stating that the Company expects "that by the end of the year the forecasted amount for capital spending would be achieved" is not the same

[6] See page 6 of Mr. Rothschild's direct testimony, Ex. DIV-5; and the hearing transcripts of September 10, 2008, starting at page 161.
[7] NGrid Initial Brief, at 17.
[8] NGrid Initial Brief, at 18.

as actually demonstrating that the forecasted spending can or will be achieved.[9] It is also worth noting that Ms. Fleck's testimony was based on the under-spending for capital projects through March 2008. Subsequent responses to outstanding data requests showed that the under-spending continued through July 2008.[10] This evidence directly contradicts the Company's claim that spending would "ramp up."[11] In fact, all the available evidence demonstrates that the Company has consistently spent less than its forecast, and by significant amounts (not "slightly below forecasted amounts"). Accordingly, the Commission should accept the Division's proposed adjustment to the Company's rate year rate base.

B. Treatment of Merger-Related Synergy Savings

In its Brief, NGrid claims as follows:

> *In that regard, the record shows that the Division's methodology produced a result that zero merger savings were realized despite testimony from the Division's witness that some level of merger savings have occurred.*[12]

This statement is inaccurate in that it is completely divorced from the proper context of what Mr. Effron was explaining during his testimony. When placed in its proper context, the statement illustrates the basic problem with the Company's

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[9] NGrid Initial Brief, at 18. It should be noted as well that NGrid's reliance on witness Fleck's testimony on this matter appears to be little more than hearsay, rather than testimony that actually reflects the witness's own knowledge on the underlying piece of critical information.
[10] See cross-examination of Sue Fleck, Tr. 9/9/08, at 10-13.
[11] Indeed, the Company's position represents another "ramp up" without supporting evidence (see *infra* Section III re: decoupling).
[12] NGrid Initial Brief, at 28.

method for calculating merger savings. Mr. Effron actually stated that although there may have been savings after the merger, if those savings are measured against a base that reflects excessive expenses, then the Company has failed to establish that a share of those savings should be included in its revenue requirement.[13]

That is, if the Company wants to include a share of merger related savings in its revenue requirement, then it has a clear obligation to establish that the savings are, in fact, attributable to the merger. In this regard, the Company has utterly failed to do so. By using a period containing <u>excessive</u> expenses as its benchmark, the Company attributes cost reductions to the merger that would, in all likelihood, have occurred even in the absence of the transaction. The expenses in the twelve months ended June 30, 2006 have never been approved as being <u>normal, reasonable expenses that are properly includable in the revenue requirement</u>. To the extent that the expenses in that period could have been trimmed back to a more normal, reasonable level even in absence of the merger, the reduction in those expenses should not be attributed to the transaction, and National Grid should not be allowed to include a share of the expense reduction in its revenue requirement.

[13] September 8, 2008 Transcript, at 187-188.

III. RATE DESIGN – TREATMENT OF NON-FIRM MARGINS

A. Sharing of Non-Firm Margin Revenues

During the hearings and as further reflected in its Initial Brief, National Grid never defended against the Division's challenge to the Company's continued receipt of Non-Firm margins. The only evidence in the record is that there is no longer any valid basis for the Company to continue receiving incentives for implementing the straight terms of the Non-Firm tariffs. Therefore, the Commission must, as a matter of law, terminate the current practice of sharing Non-Firm margin revenues. *Providence Gas Co. v. Burke, 419 A.2d 263, 268 (R.I. 1980).*

B. Fixed Rate for Non-Firm Service

On November 6, 2008, the day Initial Briefs of the parties were due in this case, National Grid filed a revised Cost of Service Study for the Non-Firm rate class. Throughout this proceeding, the Division has been mindful of the strong interest of many parties to have this Commission approve a fixed rate for the Non-Firm class as a substitute for the current "value of service" pricing regime. Despite a steadfast effort on the part of the Division to reach a mutually acceptable agreement, the Division was unable to find a solution that was acceptable to all parties. While the late-filed Cost of Service study appears to be a step forward, the Company did not provide the billing determinants that Division witness Oliver indicated in his direct testimony as a critical data requirement for implementing his Non-Firm rate recommendations. At this point, the Company's failure to provide timely cost of service information and billing determinants for the Non-Firm class would arguably bolster the Company's efforts to retain value of service pricing.

The Division shares the frustration of the Commission[14] and other parties interested in the Non-Firm rate issues regarding the inadequacies of the current record in terms of providing the Commission a clear solution for the substantial concerns that have been raised. In this context, the Division suggests that the Commission could reasonably resolve issues associated with the pricing of Non-Firm Gas Transportation service issues through the following:

1. Setting rates for Non-Firm Transportation service at a fixed discount of 20% from each customer's otherwise applicable Firm service rate;[15]

2. Establishing a revenue requirement of $2.856 million for the Non-Firm Service class based on the results for the Non-Firm (Interruptible) class presented in the revised cost of service study filed by the Company on November 6, 2008;

3. Amending the Joint Stipulation[16] regarding revenue reconciliation for Non-Firm Service such that Non-Firm

[14] The Chairman correctly pointed to the source of the problem – National Grid. Although suggesting that "there's enough blame to go around," (Tr. 10/23/08, at 203, line 24) under the tight procedural schedule of this case, coupled with National Grid's failure to comply with the Commission's order in Docket 3887, the blame can only be pointed at National Grid, and certainly not at the Division.

[15] The otherwise applicable Firm rate should be computed by dividing the sum of the projected variable distribution charge revenue and demand charge revenue for the customers' otherwise applicable rate class by the projected annual therms of gas use for the otherwise applicable firm rate class for the rate year. Customer charge revenues should not be included in that calculation and Non-Firm customers should continue to pay the customer charges established by the Commission for Non-Firm service.

> customers would share 25% of any revenue received in excess of the \$2.856 million revenue threshold while Firm customers receive the balance (75%) of any revenue in excess of that threshold.

The Division also notes that the Joint Stipulation provides the Company with full recovery of the \$2.856 million revenue requirement for Non-Firm service and insulates the Company from any risk for recovery of that amount on an annual basis. Moreover, Firm customers would receive \$1.256 million of additional benefit from Non-Firm revenues that will serve to reduce the level of rates for all Firm service classes.

IV. DECOUPLING

In it its Brief, National Grid again highlights its commitment to the environment and thus the need for revenue decoupling. In deliberating over this important issue, the Commission should have no uncertainty about why National Grid and its Executives like Mr. Stavropolous consider climate change an "extremely important issue."[17] Such a position drives the Company's agenda to obtain revenue decoupling – a mechanism that has been documented by National Grid to reduce revenue risk to "zero" in order to make National Grid, PLC an "extraordinarily low risk company." The Company's self-serving statements on

[16] See Joint Stipulation of National Grid and Division concerning the Reconciliation of Revenues from Firm and Non-Firm Dual-Fuel Customers, dated November 5, 2008.
[17] Tr. 10/22/08, at 91.

this issue should carry no weight in terms of the threshold question of whether the Commission should make the paradigm change in the way National Grid is regulated and whether decoupling is in the public interest. This is particularly so where National Grid's position would allow enrichment of the utility and its shareholders at the expense of ratepayers. The Commission should focus on the substantive evidence in the case, namely that if revenue decoupling had been deployed since the last rate case (Docket 3401), this utility would have received an additional $34.1 million from ratepayers. And despite that massive value that decoupling brings to the Company and its shareholders, National Grid vigorously argues that its return on equity should remain unaffected if the Commission allows revenue decoupling. Yes, curbing global warming and addressing climate change are, indeed, very important to National Grid.

As far as CLF's criticism of Mr. Oliver's testimony is concerned, particularly with respect to the pragmatic value of incentive-based ratemaking, Mr. Oliver clearly has very deep experience with how incentives need to be structured and which incentives actually work versus incentives that merely extract extra ratepayer money with no valid purpose. The Company's request to continue sharing in Non-Firm margin revenues is a perfect example of how an incentive that the Company seeks can appear legitimate on a surface level, but be completely at odds with true interests of ratepayers based upon the underlying substantive realities of what the "incentive" actually accomplishes. To ask the utility, or even CLF witness Mr. Kaplan, who is completely aligned with National Grid's position, whether or not an "incentive" will work or conversely, whether or not a certain rate design "will eliminate a disincentive," will always garner the same "yes" vote.

Mr. Oliver's analysis of the rate design proposal, and indeed this Commission's statutory responsibility, calls for a much more probing analysis concerning the actual impact on ratepayers versus the value of fundamentally altering the way this utility is regulated in order to accomplish some social or environmental agenda. While it may be a "no-brainer" for CLF, National Grid and its shareholders, the paradigm shift clearly poses a huge cost liability to ratepayers without concrete evidence of what actually can or will be accomplished with the so-called "ramped up" conservation programs.[18]

As a fundamental tenet in ratemaking, incentives are only justifiable where they produce a publicly beneficial change in behavior. Here, the behavior that the Commission would presumably motivate is already required by State law. To provide an incentive to a utility in order to exceed "minimal compliance" with State law makes a mockery of legislative and commission mandates.[19] Likewise, the notion that the Commission needs decoupling in order to "encourage the

[18] There is nothing in the record on the subject.
[19] A perfect example of this behavior is the Company's inexcusable failure to comply with the Commission's directive in Docket 3887 to produce a cost of service study for the Non-Firm class.

Company to use its full expertise and resources"[20] also makes a mockery of state law and regulatory mandates that any "public utility" should strive to meet. The simple fact remains that no further Commission action is necessary or even legitimate on this issue given the current state of the law and existing Commission directives.[21]

Moreover, given that ratepayers would have paid an addition $34.1 million more in rates had revenue decoupling been implemented since the last rate case, this Commission, assuming it could overcome the arguments advanced above, if it still were inclined to grant the Company revenue decoupling, had better be armed with more than a mere concept of "ramped up" DSM programs in providing the rationale for its decision, particularly given that the legislature has already mandated those programs.[22] The argument that "other commissions are doing it" is an equally unavailing argument for increasing customer rates and shareholder returns – indeed the actions of other commissions (as well as the underlying decisions) barely qualify as competent evidence for granting or denying the unprecedented decoupling request contained in this docket.[23]

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[20] NGrid Initial Brief, at 71.

[21] The mandate should carry even more force when it arises directly from legislative action – such as the existing funding for conservation programs.

[22] Ngrid states that it will return to the legislature to remove the 15 cents-per-decatherm rate cap – however, without burdening ratepayers with substantial, additional costs above what the legislature has already authorized, there is no way the Company can substantially "ramp up" the programs. Moreover, this economy simply cannot support such an additional "ramp up."

[23] This is even more so when you consider that many jurisdictions adopted decoupling through settlements where "hog trading" produced something of benefit to ratepayers. A perfect example was Mr. Oliver's case where he extracted a $6 million rate decrease for his clients. Tr. 10/13/08, at 149-52.

Overall, the evidence in the record demonstrates the almost non-existent value of what would really be accomplished with revenue decoupling beyond what is already being done today. In fact, only Mr. Oliver provided any insight regarding the limited nature of programs that would truly facilitate more cost-effective gas DSM conversation measures.[24] Ngrid witness Mr. Stavropolous didn't know – he was merely ready to motivate his employees to "reach for the stars."[25] CLF witness Mr. Kaplan did not even scratch the surface of the subject[26] – his organization was focused solely on the perceived need to "remove a disincentive." NGrid witness Mr. Simpson also did not know – in fact, upon questioning by his own attorney, he had NO information about ramped up DSM programs in jurisdictions that approved revenue decoupling, or not:

> Q. Do you know whether there is a significant number of LDCs who are implementing aggressive efficiency programs?
>
> A. I do not know that.[27]

The empty response speaks volumes about National Grid's decoupling case – it remains completely divorced or "decoupled" from any meaningful ratepayer benefit in terms of feasible, cost-effective conservation program options.[28] Mere

[24] Tr. 10/23/08, at 200-01.
[25] Tr. 10/22/08, at 108.
[26] Tr. 10/ 3/08, at 78-79. Regarding the question of cost-effective DSM programs, Mr. Kaplan generously conceded that it was a "complex subject that requires intense fact specific study ... and not something that should assumed ...."
[27] Transcript of September 26, 2008, at 232.
[28] Throughout these marathon hearings, the Chairman warned lawyers about asking questions without knowing the answers, and this instance certainly illustrated his point.

perception of a benefit to ratepayers is an inadequate basis for allowing the paradigm shift that will most definitely increase costs and burdens to ratepayers. As this case has demonstrated, National Grid has substantial resources (and had substantial opportunity in this case) to present evidence that revenue decoupling is either necessary or beneficial to ratepayers. The Company not only failed to make the case, but on balance, the record overwhelmingly supports the Division's recommendation that the decoupling proposal be rejected.

For all of the foregoing reasons, and for those reasons also contained in the Division's Initial Post-Hearing Memorandum, the Division urges the Commission to adopt all of its recommendations.

Respectfully submitted,

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Dated: November 10, 2008

CERTIFICATION

I hereby certify that on this 10th day of November, 2008, I electronically served and mailed a copy of the within pleading to all parties on the Service List compiled by the Clerk in Docket 3943.

Meghan Tobin