nationalgrid

Thomas R. Teehan
Senior Counsel

November 10, 2008

VIA HAND DELIVERY & ELECTRONIC MAIL

Luly E. Massaro, Commission Clerk
Rhode Island Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02889

RE: Docket 3943 – National Grid Request for Change of Gas Distribution Rates
Response to Issues on Gas Marketing Program

Dear Ms. Massaro:

Enclosed please find eight (8) copies of National Grid's[1] response to the Attorney General's Legal Memorandum on the Gas Marketing Program, which was filed in this proceeding on November 6, 2008. Please note that this response also responds to the Division of Public Utilities and Carriers on the issue of gas marketing.

Thank you for your attention to this transmittal. If you have any questions, please feel free to contact me at (401) 784-7667.

Very truly yours,

Thomas R. Teehan

Enclosures

cc: Docket 3943 Service List

[1] The Narragansett Electric Company d/b/a National Grid ("Company").

STATE OF RHODE ISLAND
PUBLIC UTILITIES COMMISSION

NATIONAL GRID REQUEST FOR
CHANGE IN GAS DISTRIBUTION RATES

DOCKET NO. 3943

RESPONSE TO LEGAL MEMORANDUM ON GAS MARKETING PROGRAM

SUBMITTED BY
NATIONAL GRID

NOVEMBER 10, 2008

TABLE OF CONTENTS

I. Gas Marketing Program

The post-hearing memoranda of the Attorney General's office and the Division made a number of claims and arguments relating to the Company's proposed Gas Marketing Program. The Attorney General's opposition is primarily based on a legal analysis of R.I.G.L. Section 39-2-1.2(a), which prescribes the types of "advertising costs" that are properly allowable in distribution rates.[1] Below, the Company demonstrates that (1) the Attorney General's legal analysis is off base and that the program costs are not of the type prohibited by Rhode Island law; (2) Rhode Island customers will be the direct and near-term beneficiaries of the Gas Marketing Program and will not suffer any "detriment" as a result of program implementation, and (3) the various reasons cited for the Division's opposition are groundless. Consequently, the Commission should approve the program as proposed by the Company.

A. Legal Analysis Submitted by the Attorney General

The Attorney General's legal analysis is based only in small part on Rhode Island case law. Instead, the crux of the Attorney General's legal argument lays in the interpretation of a 1972 policy statement of the New York Public Service Commission ("NYPSC"), which the Attorney General asserts and establishes the following standard:

> Expenses that subsidize a utility's unregulated service, frustrate conservation efforts, or promote the utility's principal service to the detriment of or over another energy source are not recoverable from ratepayers.[2]

Based on this premise, the Attorney General then analyzes each aspect of the Gas Marketing Program to determine whether the "program's components promote natural gas over customers'

---

1 In order to facilitate the Commission's consideration of this analysis, the Company is providing a copy of all legal authority cited herein as attachments to this reply brief.

2 Attorney General Post-Hearing Brief at 8, citing, Statement of Policy on Advertising and Promotional Practices of Public Utilities, at 12 (NYPSC February 25, 1977).

existing energy sources."[3] As one might expect, the Attorney General concludes that each expense category of the Gas Marketing Program is prohibited because the expense is incurred to encourage conversions from oil to gas service. However, there is a notable inconsistency. The standard applied by the Attorney General *is not based on Rhode Island law,* but instead on the Attorney General's (mistaken) interpretation of New York ratemaking policy. In fact, the Rhode Island statute does not encompass the "standard" used by the Attorney General to determine whether the Gas Marketing Program expenses are allowable.

In that regard, the Company's research shows the following: (1) many states have laws on the books that are similar to R.I.G.L. Section 39-2-1.2(a), and therefore, the background and purpose of these laws is probative in this case; (2) the Attorney General's analysis of the ratemaking policy applied by the NYPSC to gas marketing expenses is off base because the NYPSC allows *and encourages* the recovery of gas marketing costs through rates, and (3) the Attorney General has not correctly portrayed applicable Rhode Island case precedent, which actually supports the inclusion of gas marketing costs in rates. Each of these principles is discussed in turn below.

1. Statutory Advertising Prohibitions Are Common and Have the Effect of Prohibiting Costs Associated with "Branding" or "Institutional" Advertising, Not Gas Marketing Costs

In his Post-Hearing Memorandum, the Attorney General places a significant emphasis on findings in other jurisdictions relating to various factual disputes over the recovery of advertising expenses. Specifically, the Attorney General claims that courts in other jurisdictions uphold public utility commissions when they have "denied advertising expenditures that are aimed

[3] Id. at 9.

solely at achieving a rate increase," or that are "promotional and excessive in magnitude."[4] On the basis of these findings in other jurisdictions, the Attorney General asserts that "a principle purpose of the prohibition of G.L. Section 39-2-1.2(a) is to prevent the waste of ratepayer monies resulting from the unnecessary expenditure of such funds on promotional activities."[5] The Attorney General does not cite Rhode Island case law or legislative history for this proposition.

In that regard, R.I.G.L. Section 39-2-1.2(a) states as follows:

> § 39-2-1.2 Utility base rate - Advertising, demand side management and renewables. - (a) In addition to costs prohibited in § 39-1-27.4(b), ***no public utility*** distributing or providing heat, electricity, or water to or for the public ***shall include as part of its base rate any expenses for advertising, either direct or indirect, which promotes the use of its product or service, or is designed to promote the public image of the industry***. No public utility may furnish support of any kind, direct, or indirect, to any subsidiary, group, association, or individual for advertising and include the expense as part of its base rate. ***Nothing contained in this section shall be deemed as prohibiting the inclusion in the base rate of expenses incurred for advertising, informational or educational in nature, which is designed to promote public safety conservation of the public utility's product or service.*** The public utilities commission shall promulgate such rules and regulations as are necessary to require public disclosure of all advertising expenses of any kind, direct or indirect, and to otherwise effectuate the provisions of this section.

R.I.G.L. Section 39-2-1.2(a) (emphasis added).

Significantly G.L. Section 39-2-1.2(a) *does not bar the recovery of advertising expense* from distribution rates. As implied by the language of G.L. Section 39-2-1.2(a), there is a need to differentiate (1) costs that are incurred to promote the general use of utility service, or promote the public image of the utility, from (2) costs that are incurred by the utility for information or educational advertising that is designed to promote public safety and/or conservation of the public utility's product or service. *This distinction is important and similarly exists in other state*

[4] Attorney General at 4; Id., citing, Bonbright, Principle of Public Utility Rates at 8 (1961); El Paso Electric Co. v. New Mexico Public Service Commission, 706 P.2d 511, 514 (N.M.); Application of Hawaiian Electric Co., 535 P.2d 1102, 1108-09 (Haw. 1975); East Ohio Gas Co. v. Public Utilities Comm'n of Ohio, 437 N.E.2d 594, 595 (Ohio 1982).

jurisdictions. Specifically, state jurisdictions typically differentiate between costs incurred for "branding" or "institutional" advertising (which are not allowed in rates) and costs incurred for educational or informative advertising that advises customers on their service options (which are allowed in rates).

Therefore, while the Company agrees that findings made by other state jurisdictions cited by the Attorney General may have probative value in this case, it is necessary to be very clear about whether the jurisdictional precedent relates to (1) institutional or branding advertising costs, (2) advertising costs that are disallowed because of their "wasteful" or imprudent nature, and (3) advertising costs that are incurred to promote a gas conversion or other utility program that is beneficial to customers. In other words, any discussion regarding legal prohibitions on advertising in other jurisdictions must be specific in terms of the types of promotional spending subject to review and approval/disallowance in any given case. When this specificity is applied, it becomes clear that the general rule is to prohibit the recovery of institutional or branding-type advertising, which is generally regarded as benefiting shareholders, and to allow promotional advertising expense where it directly educates, informs and benefits customers.

For example, in Massachusetts, the ratemaking treatment for promotional spending is set forth in M.G.L. c. 164 § 33A ("Section 33A"), which states:

> No gas or electric company regulated by the department under this chapter may recover from any ratepayer of such company any direct or indirect expenditure by such company for promotional or political advertising as defined in this section.
>
> For the purposes of this section, the following words and phrases shall have the following meanings:—
>
> "Advertising", the commercial use by a utility of any media, including newspaper, printed matter, radio, and television, in order to transmit a message to a substantial number of members of the public or to such utility's consumers.

[5] Attorney General Post-Hearing Brief at 4.

> "Political advertising", any advertising for the purpose of influencing public opinion with respect to legislative, administrative, or electoral matters, or with respect to any controversial issue of public importance.
>
> "Promotional advertising", any advertising for the purpose of encouraging any person to select or use the service or additional service of a utility regulated by the department, or the selection or installation of any appliance or equipment designed to use such utility's service.
>
> For the purposes of this section, the terms "political advertising" and "promotional advertising" **shall not include advertising which informs consumers of any utility on how they can conserve energy, reduce peak demand for energy, or other services, or otherwise use the services of any utility in a cost-efficient manner**; is required by federal or state laws or regulations; informs consumers regarding service interruptions, safety measures, or emergency conditions; concerns employment opportunities with a utility; or relates to any explanation or justification of existing or proposed rate schedules, or notification of hearings thereon which informs consumers of and **stimulates the use of products or services which are subject to direct competition from products or services of entities not regulated by the department or any other government agency.**

In Boston Gas Company v. Dept. of Public Utilities, 539 N.E.2d 1001 (Mass. 1989), which followed the enactment of Section 33A, the Supreme Judicial Court ("SJC") was asked to review a decision by the Massachusetts Department of Public Utilities (the "Department") disallowing recovery of "institutional advertising" costs, or advertising that is "designed to improve the image of the company and that contains no information which might be directly helpful or beneficial to the Company's customers."[6] The SJC noted that the language of Section 33A was taken largely from the Federal Public Utility Regulatory Policies Act of 1978.[7] The SJC further noted that the objective of that Act was to "promote energy conservation by federally regulated utilities in response to the nationwide energy crisis and to encourage States to adopt

---

6 Boston Gas Company v. Dept. of Public Utilities, 539 N.E.2d 1001, at 116 (Mass. 1989).

7 Id. at 118; citing, 16 U.S.C. § 2623(b)(5) and § 2625(h)(2) (1982) (electric utilities) and 15 U.S.C. § 3203(b)(2) and § 3204(b)(2) (1982) (gas utilities).

similar regulations," based on the proposition that, if the use of energy was not encouraged by promotional advertising, less energy would be used.[8]

In considering the appeal of Boston Gas Company, the SJC stated that:

> This case, of course, does not involve promotional advertising. Promotional advertising is advertising designed to inform customers of new service or of other information that might be helpful or economical[9]. . . . The debate . . . in this case, is over institutional or image advertising.[10]

In the end, the SJC upheld the Department's disallowance of institutional or branding costs from rates. The Court's reasoning was as follows:

> We thus agree with the Department, and the strong trend of judicial decisions . . . , that the cost of institutional or image advertising **may be treated as a cost of service only if it benefits ratepayers directly**.[11]

Although the Massachusetts statute is, in some respects, more precisely worded than the Rhode Island statute, the Massachusetts case provides an important context on the issue of allowable promotional expenses across state jurisdictions. In that regard, it is significant for purposes of this case that the debate is centered on the potential recovery of institutional or branding costs -- costs which are generally held to benefit shareholders – and not on promotional advertising expenses, which are incurred to inform customers of a new service or provide other helpful or economical information. Moreover, even institutional and branding costs may be allowable, where there is demonstrated customer benefit.[12] As discussed below, the ratemaking

---

8 Id., citing, Federal Energy Regulatory Commission v. Mississippi, 456 U.S. 742, 745, 102 S.Ct. 2126, 2130.

9 Id. at 118-119, citing, New England Telephone Company v. Department of Pub. Util., 360 Mass. at 482 (1971).

10 Id. at 119.

11 Id. at 119-120 (emphasis added). See, footnote 3, listing cases where the court has upheld agency regulations or decisions excluding institutional advertising from a utility's cost of service *unless the utility could show a benefit to ratepayers.*

12 Id.

policies of the NYPSC do not differ from this construct, and therefore, the Attorney General's reliance on NYPSC precedent is off base.

2. The NYPSC's Ratemaking Policy Is to Allow and Encourage Gas Marketing by Regulated Gas Utilities.

The Attorney General states that the NYPSC takes a "broad view" of the "general prohibition" on advertising costs, "barring the use of ratepayer monies to subsidize promotional activities of public utilities."[13] This is not accurate.

The Attorney General stakes his claim on a 1977 policy statement reiterating findings first developed in a similar policy statement in 1972.[14] The Attorney General references a specific paragraph in the policy statement directing all gas distributors to cease all promotional activities designed to acquire new customers, including efforts to "obtain or arrange," gas conversions.[15] The Attorney General contends that this policy was reaffirmed as recently as January 2008 in a case involving Consolidated Edison Company of New York, Inc. ("ConEd"), where the NYPSC stated that "[t]he policy statement continues to have a valid purpose and it can be put to good use in today's circumstances."[16] Based on this case, the Attorney General concludes that "the Statement's limitations on promotional activities remain in effect."[17] However, upon closer review, this is not the case.

As an initial matter, the case cited by the Attorney General is a recommended decision, not the final decision of the NYPSC in that docket, and although not noted by the Attorney

---

13 Attorney General Post-Hearing Memorandum at 5.

14 Id., citing, Statement of Policy on Advertising and Promotional Practices of Public Utilities (1977) (the "1977 Policy Statement").

15 Id., citing 1977 Policy Statement at 6.

16 Id., at 6, citing, Proceeding on Motion to Commission as to Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc., for Electric Service, Case 07-E-0523, at 43-44, 47 (January 8, 2008).

17 Attorney General Post-Hearing Memorandum at 6.

General, the case involved ConEd's electric operations not gas. The NYPSC's final decision was issued on March 25, 2008 in Case 07-E-0523. In that Order, it is clear that the issue before the NYPSC was whether it should approve ConEd's request to increase its **allowable institutional advertising expense** from 0.06 percent of its operating revenues for informational and institutional advertising to 1.0 percent of its operating revenues. The 0.6 percent of revenues *allowable expense* is established in the 1977 Policy Statement.[18] ConEd argued that the expense allowance should be updated and increased to 1.0 percent to reflect changed market circumstances in light of electric industry restructuring and other events.[19] The NYPSC denied this request, stating that:

> In response [to ConEd's proposal], Staff supports the application of the advertising policy statement and states that important information and public messages need not be curtailed. **Staff also distinguishes informational and institutional advertising from the Company's outreach program** that is used to inform customers of their rights, responsibilities and safety matters, and to provide pertinent information about contacting the Company. **These efforts will not be affected by the application of the policy statement to curtail the Company's use of ratepayer provided funds for self-serving advertisements.**
>
> We agree with Staff that reliance on the 1977 policy statement **on informational and institutional advertising** should not affect Con Edison's important consumer outreach efforts, which are separately budgeted and accounted for in rates. . . . Separate from these outreach funds, however, is the funding for this informational and institutional advertising category. Because evaluation of the appropriate level of such advertising is a much more subjective enterprise, reliance on the policy statement's guidelines has continuing merit and application here. The policy statement continues to have a valid purpose and it can be put to good use in today's circumstances and conditions. We are therefore adopting Staff's proposal for a 0.6% allowance that is the standard for a company of Con Edison's size.[20]

In fact, the NYPSC differentiates "information and institutional" advertising costs from "sales promotion costs," with sales promotion costs included in the rates of every major New

---

[18] Case 07-E-0523, at 45-46.

[19] Id.

[20] Case No. 07-E-0523, at 46-47. See, also, 1977 Policy Statement creating percentage values for electric operations.

York distribution company for many years.[21] In New York, sales promotion costs include gas marketing expenses. For example, in establishing rates for the gas operations of the Long Island Lighting Company ("Lilco"), the Commission stated that:

> More generally, gas is a desirable fuel and its efficient use should be encouraged. To that end, substantial funds are provided here for the promotion and expansion of Lilco's gas service and the Company is expected to pursue those efforts.[22]

Most recently, in ConEd's most recent gas distribution rate case, the NYPSC authorized ConEd to recover the costs of its oil-to-gas conversion program through a per therm surcharge.[23]

Thus, the Attorney General's reliance on New York ratemaking precedent is wholly misplaced, but indicative of the confusion that may arise in relation to a discussion on allowable advertising expense if the specific attention is not paid to the differentiation between institutional or branding costs and allowable promotional expense, which benefits customers.

3. Rhode Island Case Law Similarly Supports the Inclusion of Gas Marketing Costs in Rates.

A review of Rhode Island case law relating to R.I.G.L. Section 39-2-1.2(a) makes it clear that the Rhode Island statute operates in a fashion that is substantially similar to the framework in place in other state jurisdictions. For example, the plain language of the statute makes it clear that: (1) costs for advertising *may* be included in rates so long as the advertising is informational and educational in nature and directed at promoting the public safety or conservation, and (2) costs *cannot* be included in rates if the advertising is designed to generally promote the use of

---

[21] See, e.g., Long Island Lighting Company, Case 91-G-1328, Opinion No. 92-35 (November 25, 1992) (approving gas marketing costs in rates).Long Island Lighting Company, Case 93-G-0002, Opinion No. 93-23 (December 23, 1993) (approving gas marketing costs in rates); Brooklyn Union Gas Company, Case No. 93-6-0941, Opinion 94-22 (October 18, 1994); Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc. for Gas Service, Case 06-G-1332 (September 25, 2007).

[22] Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Long Island Lighting Company for Gas Service, Case 91-G-1328 (Opinion No. 92-35) (1992).

[23] Decision issued 9/25/2007 in docket 06-G-1332.

natural gas or enhance the public image of the natural gas industry.[24] Although there is not a wealth of Rhode Island case law on the topic, the case law that does exist indicates that the types of expenses that would be incurred through the Gas Marketing Program are not prohibited by the application of R.I.G.L. Section 39-2-1.2(a).

There are three probative statements on the recovery of advertising expense under Rhode Island case precedent. First, in 1980, the Commission found that the word "conservation" set forth in R.I.G.L. Section 39-2-1.2 should be interpreted broadly to include conservation in general. Specifically, in reviewing advertising expenses in Narragansett Electric Company, Docket No. 1499, Order No. 10299 (1980), the Commission stated that:

> R. I. General Laws Sections 39-2-1.2 and 39-3-12.1 as amended, address the prohibition of recovery of certain advertising expenses in much the same vein as the PURPA advertising standard. . . . After review and consideration of the record, we find that the advertising standard as modified below conforms to State law and is appropriate to serve the three goals of PURPA. We therefore adopt the following standard concerning advertising as it affects the Company:
>
> Narragansett Electric Company ("Company") may not recover from any person other than its shareholders (or other owners) any direct or indirect expenditure for promotional or political advertising. The Company may not include as part of its rate base or cost of service any expenses for advertising, either direct or indirect, which promotes the use of electric service, is designed to promote the public image of the electric utility industry, or promotes the construction of a nuclear facility for the generation of electricity. The Company may not furnish support of any kind, direct or indirect, to any subsidiary, group, association, or individual for such advertising and include such expense as part of its rate base or cost of service. Notwithstanding the foregoing, the Company **may include in its rate base or cost of service expenses incurred for informational or educational advertising, which is designed to promote conservation of electric service**. The Company shall publicly disclose all advertising expenses of any kind, direct or indirect. "Advertising" means the Company's commercial use of any media, including newspaper, printed matter, radio, and television, in order to transmit a message to a substantial number of members of the public or to the Company's electric consumers. "Political advertising" means any advertising for the purpose of influencing public opinion with respect to legislative, administrative, or electoral matters, or with respect to any controversial issue of public importance. "Promotional advertising" means any advertising for the purpose of encouraging

[24] G.L. R.I.G.L. Section 39-2-1.2(a).

> any person to select or use the Company's service or additional service or the selection or installation of any appliance or equipment designed to use the Company's service. "Political advertising" and "promotional advertising" do not not include advertising which **informs electric consumers how they can conserve energy** or can reduce peak demand for electric energy, advertising required by law or regulation (including advertising required under part 1 of Title II of the National Energy Conservation Policy Act), advertising regarding service interruptions or safety measures or emergency conditions, advertising concerning employment opportunities with the Company, **advertising which promotes the use of energy efficient appliances or equipment or services** or any explanation or justification of existing or proposed rate schedules or notifications of hearings thereon.[25]

Notably, this language was agreed to by Narragansett Electric and the Division and is a verbatim copy of the Massachusetts statutory provision discussed above (Section 33A), with the exception that the last statement pertaining to natural gas service is omitted (as one would expect since the case was an electric rate case).[26] If the Commission were to adopt the Massachusetts standard for the Company's *gas* operations, the following phrase would be added just after the words "or notifications of hearings thereon," stating "and stimulates the use of products or services which are subject to direct competition from products or services of entities not regulated by the department or any other government agency." The Attorney General does not reference this case in his Post-Hearing Memorandum.

Secondly, the Rhode Island Supreme Court had occasion to review the Commission's finding on advertising costs in Valley Gas v. Burke.[27] In that case, the Company proposed advertising expense totaling $63,683, of which $53,648 were found to be unrecoverable under R.I.G.L. Section 39-2-1.2(a).[28] The remaining amount, $10,085, related to an advertising

---

25 Narragansett Electric Company, Docket No. 1499, Order No. 10299 (1980). Significantly, this premise was stipulated to by the utility and the Division in Docket 1499

26 The omitted provision follows the words "or notifications of hearings thereon," would add the words "and stimulates the use of products or services which are subject to direct competition from products or services of entities not regulated by the department or any other government agency."

27 Valley Gas v. Burke 518 A.2d 1363, 1367 (R.I. 1986).

28 Id.

program called the "American Gas Association Communications Program.[29] Valley Gas argued that the advertising is "informational and educational in nature and is designed to promote the efficient use of natural gas," and therefore the cost should be recoverable.[30] The Commission allowed the AGA expenses stating that:

> The AGA campaign was entitled "The Future Belongs to the Efficient." It consisted, in part, of print advertisements extolling the efficiency with which certain gas furnaces, ranges, water heaters, and other major home appliances operate, and further estimating the amount of money consumers would save by using these efficient products rather than standard, older models.
>
> A review of the advertisements confirms their informational, rather than promotional, nature. The advertisements primarily encourage the use of certain, more efficient, gas appliances over other gas appliances and as such, **encourages conservation rather than merely promote the use of gas. This is precisely the type of advertising that the exception within § 39-2-1.2** allowing for advertising of an informational or educational nature **was meant to encourage**, and thus we see no reason to overturn the decision of the commission with regard to the allowance of recovery of AGA Communications Program expenses.[31]

In his legal memoranda, the Attorney General accurately reviews the disposition of the Valley Gas case, but contends that it is notable because of the *denial of advertising expenses*, which the Attorney General asserts has been followed in other state jurisdictions.[32] However, the specific nature of the denied expenses is not referenced in the decision, nor are the denied expenses a focus of the Court's decision. Instead, the crux of the Court's analysis centered on Commission's decision to allow the expenses associated with the AGA campaign, which promoted the use of efficient gas heating equipment. The Court affirmed the Commission's decision on that point, establishing the concept that advertising expense geared toward the promotion of efficient energy use is recoverable in rates.

---

29 Id.

30 Id.

31 Id. (emphasis added).

32 Attorney General at 3-4.

Subsequent to the Valley Gas case, the Commission allowed recovery for proposed advertising expenses for Providence Gas Company on the basis that the costs were incurred for activities that are "part of the Company's normal informational, marketing and sales efforts, and that therefore, do not fall under the proscription contained in R.I.G.L. Section 39-2-1.2(a)."[33] Specifically, in Providence Gas Company, Docket No. 2286, Order No. 14859 (1995), the Company requested recovery of $1,394,038 in "advertising expenses," which was comprised of a number of cost categories.[34] The Commission stated that 61 percent of the total requested amount, or $847,000 constituted "labor" expense for the Company's marketing staff.[35] In reaching this finding, the Commission stated "the marketing staff is involved in a wide range of activities. It answers customer inquiries, it arranges for new services, it works with the Company's trade allies *and promotes increased sales*."[36] In the final analysis, the Commission allowed $937,000 of the total request of $1,394,038.[37] However, the amount *allowed* by the Commission ($937,000) included the costs of a number of sales and marketing activities, including: (1) providing information and service to existing and prospective customers to service their energy needs ($498,063); (2) coordination of the trade allies program ($60,889); (3) promotions and direct mailings ($6,889); (3) administration of contractor rebates ($1,975); (4) safety information and education including information press releases and rate brochures ($66,846), and (5) market research ($38,030).[38] These costs are no different than those involved in the Gas Marketing Program.

---

33 Id.

34 Providence Gas Company, Docket No. 2286, Order No. 14859 (1995).

35 Id.

36 Id. (emphasis added).

37 Id.

38 Id.

The Attorney General focuses on the amount that the Commission *did not allow*, which totals $457,000.[39] However, the Commission's Order does not specify the nature of the costs that were not allowed in rates. The Attorney General states that the disallowed costs were "promotional, goodwill and advertising expenses, but this characterization was made by the Division's witness in opposing recovery, not by the Commission in denying a portion of the total request.[40] Given the cost categories that were specified as *qualifying for recovery*, the Providence case is wholly supportive of the recovery of costs such as those the Company would incur to conduct the Gas Marketing Program.

Thus, it is in the public interest that Commission policy on gas marketing expense remains consistent with prior precedent of the Commission and the Rhode Island Supreme Court, in that such expenses have been determined to be allowable under R.I.G.L. Section 39-2-1.2.

4. Summary of Legal Analysis

The legal theory espoused by the Attorney General on the issue of gas marketing expense is that R.I.G.L. Section 39-2-1.2 "broadly bars the Company from recovering, or the Commission from ordering in a utility's rate base, expenses for activities that promote natural gas over customers' existing sources of energy."[41] The Attorney General argues that each component of the Gas Marketing Program fails this test because they are "precisely the type of expenses that fall within the bar contained in R.I.G.L. Section 39-2-1.2."[42] However, as the foregoing analysis demonstrates: there is no standard prohibiting expenses for activities "that promote natural gas over a customer's existing sources of energy," as suggested by the Attorney General. This standard is not generally applied or referenced in jurisdictional case law; nor is it

---

39 Id.

40 Id.

41 See, e.g., Attorney General at 11.

applied by the NYPSC, and it certainly is not encompassed within the plain language of R.I.G.L. Section 39-2-1.2, or referenced in <u>any</u> Rhode Island case law.

To the contrary, the applicable case precedent established by the Rhode Island Supreme Court stands for the proposition that the Gas Marketing Program costs fall well within the exception found in R.I.G.L. Section 39-2-1.2, because the Gas Marketing Program is designed to encourage gas conversions by (1) "extolling the efficiency" of gas furnaces and other major home appliances, (2) raising customer awareness regarding the amount of money consumers would save by using these efficient products rather than standard, older models, (3) providing informational materials that encourage the use of newer and more efficient gas appliances, and (4) encouraging conservation rather than merely promoting the use of gas. Accordingly, the provisions of R.I.G.L. Section 39-2-1.2 cannot properly be relied on as requiring the denial of Gas Marketing Program expenses – both the Commission and the Court have read this provision so as to allow the recovery through rates of costs that are incurred for the purpose of promoting cost-efficient energy usage and overall energy conservation because these objectives, along with environmental protection, provide a sound public interest policy.

Moreover, it is important to emphasize that of the total funds requested by the Company for the Gas Marketing Program ($1.377 million), only a portion relates to customer communications expenses of the type that may be considered 'advertising expense." A significant portion of the total budget is for other program costs such as rebates, discounts, staffing and other expenses necessary to conduct the program, but not constituting costs of customer communications. This is important because the prohibition in Section 39-1-2.1 only applies to advertising expenses (and then only prohibits a certain category of advertising).

---

[42] R.I.G.L. Section 39-2-1.2.

In that regard, the Attorney General attempts to argue that the phrase "advertising, either direct and indirect " encompasses the Gas Marketing program costs such as rebates, discounts, staffing although these costs do not constitute customer communications. However, even assuming that the customer communication under the Gas Marketing Program was "promotional" in nature and did not promote "conservation" in some form, the rebates, discounts and staffing *are not* direct or indirect costs of advertising. The Commission has not addressed what constitute direct or indirect in relation to advertising; however, rebates, discounts and staffing do not reasonably constitute indirect costs of advertising.

Lastly, although customer communication costs are distinguishable from other program costs, disallowance of even a part of the program costs would undermine the Company's ability to achieve the results possible with the planned budget.[43] There would still be a need for staffing to respond to customer initiated request for conversions. There would still be a need to have discounts and rebates available to consumers who on their own initiative contact the Company to seek conversion in order to address the large upfront investment of capital required for conversion. In fact, the "incentive amount is really the key to the decision making of the customer."[44]

B. The Gas Marketing Program Will Produce Direct Customer Benefits

In addition to his legal arguments, the Attorney General claims that the Company has not provided evidence to show a "causal connection" between the proposed expenditure of customer funds and a direct customer benefit.[45] The Attorney General further claims that the Company has not presented any evidence that the Program's project internal rate of return ("IRR") exceeds

[43] Tr. 10/20/08 at 248.
[44] Tr. 10/20/08 at 249.
[45] Attorney General at 14-16.

the Company's allowed rate of return, in the absence of the "price differential effects" between the price of natural gas and heating oil.[46] For the reasons discussed below, these claims do not have any merit and therefore should be rejected by the Commission.

First and foremost, the record shows that inclusion of the proposed Gas Marketing Program expenses in rates will have a direct benefit for customers. The record evidence in support of this conclusion is as follows:

1. The Gas Marketing Program is targeted on adding customers who are currently taking non-heating gas service from the Company ("low-use customers") and customers not currently taking case service but located on the existing gas distribution system. The Gas Marketing Program is not available to new gas customers who are *not located* on the existing distribution system, i.e., where new mains are constructed, customers may take service through the Company, but will not participate in the Gas Marketing Program. The record shows that 95 percent of customers added as a result of new construction select natural gas as their home heating resource; therefore, these customers are not included in the Gas Marketing Program.

2. The Company prepared an analysis of the internal rate of return associated with the program, which demonstrates that the customers added through the Gas Marketing Program will produce revenues in excess of the costs to add them to the system, which has the direct effect of increasing the amount of revenues available to recover the Company's fixed costs.[47] Based on this analysis, new residential customers would produce a return of 14.8 percent on average, and C&I customers would produce a benefit of 21.4 percent on average.[48] By comparison, the Company's proposed rate design anticipates a rate of return for residential

---

[46] Id.
[47] Exh. NGRID-6 , at Attachment NG-SPM-1.
[48] Id.

heating customers (based on proposed rates) of 9.38 percent.[49] This IRR analysis is uncontested in the record for the proceeding and establishes the "cost causation" link that the Attorney General claims should apply to the Gas Marketing Program.

3. The Company does not conduct the Gas Marketing Program based on the relative price differential between oil and gas. The price of oil and gas will always fluctuate over time, with the differential favoring one fuel or the other at any given time. The targets for the Gas Marketing Program apply from year to year, regardless of any differential in price for heating oil and natural gas.

4. The Company's experience is that in times where the price differential favors natural gas, the Company will exceed its target levels for customer additions. However, because the Gas Marketing Program operates independent of market price fluctuations in the oil and gas markets, the Company's marketing efforts *do not cease* during these periods. The Company continues to perform customer outreach and customers continue to be eligible for equipment rebates, with the result being that the Company is able to take advantage of the greater motivation for gas conversions provided by the price differential and achieve an even greater level of conversions; however, the Company does not avoid any program costs.

5. Because no program costs are avoided during periods when a price differential favors natural gas the IRR for the Gas Marketing Program may increase in terms of the customer benefit (because more customers are added with the same program costs), but the IRR will not fall below the calculated IRRs because the program dollars are used *in combination with the price differential* to spur customer additions.

[49] Attachment NG-DAH-2 page 1 of 4, line 36

6. The Company has agreed to retain the annual earnings sharing mechanism ("ESM"), which operates to provide customers with 50 percent of any earnings over the authorized rate of return up to 100 basis points and 75 percent of any earnings achieved in excess of the authorized rate of return plus 100 basis points. The Company testified that in the first years after a customer is added, the revenues will serve only to offset the costs of the customer addition; however, the IRR calculation demonstrates that the revenues available from the customer will be fully offset and exceeded, producing excess revenues for the system. With the annual ESM in place, customers will be the direct beneficiaries of those additional revenues.

7. In addition, any growth that is achieved will be factored into the billing determinants in the next base-rate proceeding.

Contrary to the claims of the Attorney General, the record shows that the Gas Marketing Program will directly benefit customers in both the near and long-term. Accordingly, the Commission should approve the recovery of costs for the program.

C. Other Concerns Voiced by the Division and the Attorney General Are Not Substantiated in the Record.

The Division makes a number of claims regarding the Gas Marketing Program, which do not include a claim that the program is not allowed by law. The Division's concerns are stated as follows: (1) the program will be "distortive of, and potentially injurious to, existing competitive market structures; (2) the program is misleading in elements of the information offered to potential customers; and (3) the program inappropriately exposes the 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."[50] Similarly, the Attorney General claims that the record shows that customers will be "harmed" if they are

[50] Post-Hearing Memoranda of the Division at 22.

required to "reimburse" the Company for program expenses because customers would be subsidizing the marketing activities of the Company's unregulated affiliate.[51]

1. Anti-Competitiveness: The Company finds it difficult to respond to the claims of the Division and the Attorney General on the potential "anti-competitive" nature of the Gas Marketing Program, because the claims are entirely vague and disparate in nature. For example, the Division alleges that the program is "distortive of" and "potentially injurious of" competitive market structures, but articulates no theory as to how that would occur. At bottom, there is no substantiation in the record that any aspect of the Gas Marketing Program will, in fact, have an anti-competitive impact on the marketplace.

Concerns were voiced that providing equipment to converting customers at a cost available to National Grid's regulated operations through a bulk purchase agreement would negatively impact plumbing and heating contractors who sell the same equipment; however, the record also indicates that local plumbing and heating contractors benefit greatly from the sales leads that are generated for them through the VPI Program.

Concerns were also voiced that the Company's unregulated heating and cooling affiliate would improperly benefit from participation in the VPI Program; however, the record demonstrates that the Company's affiliate would participate on an equal footing with all other participating contractors, and has historically been responsible for only a very small percentage of the total conversions arising out of the Gas Marketing Program (5 percent). On this point, the Division asserted that "it is National Grid Energy Services that becomes the dominant beneficiary of marketing expense being borne by ratepayers, second only to National Grid, the utility.[52] However, there is no basis in the record whatsoever to support this claim, nor does the

---

[51] Id. at 16-20.

[52] Post-Hearing Memoranda of the Division at 25.

Division cite to any record evidence. The Company testified that National Grid Energy Services is an irrelevant factor in establishing the Gas Marketing Program, and based on history, will be only a minor player in the VPI program. Even if competitive issues existed with the energy services affiliate, *which they do not*, it would not make any sense for the Commission to deny the program (and the benefits that it would produce for customers) as opposed to imposing reasonable controls or standards of conduct to govern the affiliate relationship. Accordingly, these vague claims should not in any way dissuade the Commission from approving a program that would provide direct benefits to customers.

2. Misleading Elements. The Division claims that the Gas Marketing Program contains "misleading elements," but does not provide any indication of what this means. There is no record evidence, testimony or exhibits that tend to demonstrate that any aspect of the Gas Marketing Program is misleading.

3. Inappropriate Risk for the Utility. The Division claims that the Gas Marketing Program creates "inappropriate risk for the utility." Again, the Division does not articulate a specific theory to which the Company could respond. However, if the claim is in relation to the customer satisfaction guarantee and the Company's willingness to assume the risk of assisting customers who have a problem, the record shows that this is a very rare incident *because the program works* and therefore no material risk is involved, even if it were somehow "inappropriate" for the Company to offer these protections to customers, which it is not. [53]

4. Costs Associated with Customer Additions

One other issue that requires a response is the Division's claims regarding the cost of customer additions. Specifically, the Division states that "the Company's claims that its costs of

[53] Tr. 10/20/08, at 179.

adding new customers exceed its expected incremental revenue are unfounded."[54] The Division asserts that the Company has focused its marketing program on adding customers *for whom no additions to distribution mains are necessary* and that, for this reason, the Company can add targeted customers "at costs significantly below the average costs upon which rates will be based" thereby adding to the Company's profitability.[55] This is not correct.

As an initial matter, there is the cost of attracting customer additions, which is required to achieve the target growth levels. In addition, as stated above, there are two categories of customers that may be added to the system through the Gas Marketing Program, which are:

1. **Low-use customers** who are already hooked up to the system, but are taking non-heat gas service. These customers will require minimal capital investment to complete a gas conversion because they already have a meter and service.

2. **New customers who are not hooked up to the system**, but are located on the existing distribution main. These customers require more capital investment because a meter and service will have to be installed, at a minimum.

There are capital costs involved in achieving the customer additions through the Gas Marketing Program. Specifically, Attachment NG-SPM-1 shows that the total capital associated with adding the annual target number of low-use customers is $120,500 and the total annual capital associated with adding new residential customers who are located on the existing distribution system is $1,785,900, for a total of almost $2 million per year in capital costs needed to add these residential customers (plus $1.67 million to add business customers). In addition, the Company has repeatedly stated that it is necessary to incur marketing costs in order to achieve the target level of customer additions, because it is necessary to overcome the obstacles to gas conversions (i.e., information and cost). Neither program costs nor capital costs beyond

54 Id. at 22.

55 Id. (emphasis added).

the rate year is included in rates. Yet with the ESM in place, the Company must share the profitability that arises from these new customer additions even though it has made the O&M and capital investments out of shareholder money. Accordingly, the Division's assertions on this point are not accurate.

5. Shareholder Funding

The Division posits that the costs of the Gas Marketing Program are already being funded out of shareholder funds, and therefore, the program will continue even if the Commission rejects cost recovery in rates.[56] This also is not accurate. When asked if the Company would continue the program in the absence of Commission approval, the Company testified that:[57]

> I can't say that, and the reason I can't is. . . I go back to the amount of the time required to actually receive payback, even payback. Forget about IRR return. You're talking about an investment that we are making right now. If it involves capital, you're talking about a [$3,000] investment. If [you assume] the $450 that we're going to receive in margin, you're talking about a five or six-year simple payback. If rates are – if we go into rate making every couple of years, every three years, then the value [for shareholders] won't be there. It's going to take five years to get a simple payback. We would have already adjusted rates for the new revenues.
>
> So. relative to the regulated portion, **it would be difficult for the Company to commit that we would sustain making this investment on behalf of the shareholders if there isn't a logical business return.** It wouldn't make sense for us to commit to sustaining this level of investment.

In addition, the Division argues for the exclusion of Gas Marketing Program costs while at the same time recommending that all of the growth revenues achieved in this year while the Company has commenced its gas marketing efforts should remain in rates.[58] As a result, it is clear that the Division recognizes that growth is good for customers, but somehow is unwilling to invest in growth for the benefit of customers. Under the ratemaking framework that will be in

---

56 Post-Hearing Memoranda of the Division at 24.

57 Tr. 10/20/08, at 210, 212; tr. 10/22/08, at 56.

58 Post-Hearing Memoranda of the Division at 22.

place in Rhode Island following this rate case, including the Company will be unable to retain the margins associated with growth in the number of customers and in excess of the costs to add the customer. Because these margins flow directly to customers through the operation of the ESM, it is in the interests of customers, particularly in this difficult time, to authorize the Gas Marketing Program. In fact, despite all of the various and sundry concerns raised by the intervenors, the Gas Marketing Program stands as one of the most effective tools that the Commission could adopt to help to ensure the affordability of rates over the long term. Accordingly, it is in the public interest to commence funding of this program through rates.