

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 Post Hearing Memoranda**

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Dear Ms. Massaro:

Enclosed please find eight (8) copies of National Grid's<sup>1</sup> response to the Post-Hearing Memoranda filed by parties to this proceeding on November 6, 2008.

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

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<sup>1</sup> 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**

**REPLY MEMORANDUM**

**SUBMITTED BY  
NATIONAL GRID**

**NOVEMBER 10, 2008**

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## **I. Introduction**

On November 6, 2008, the Commission accepted a post-hearing memorandum from each of the parties in this proceeding. Several claims were asserted in those memoranda that the Company believes require a response.<sup>1</sup> These claims and the Company's response can be summarized as follows:

## **II. Capital Structure**

The Commission's findings on capital structure are important because the "authorized rate of return" to be built into rates will be derived by multiplying the approved cost of capital by the approved capital structure to produce the weighted cost of capital.<sup>2</sup> The weighted cost of capital is then multiplied by the total allowable rate base to produce the return component of base rates.<sup>3</sup> For the Company, an understanding of this exercise is important because the authorized rate of return represents the single most important factor in setting rates that signal both management and the market that investment in Rhode Island should take place.<sup>4</sup>

However, an understanding of this exercise is also important in terms of understanding the fallacy of the Division's position on capital structure. The Division's central thesis on capital structure is that financing now takes place at the National Grid plc level, and therefore, the level of common equity used in setting the rate of return for the regulated gas company in Rhode Island should be no higher than the level of common equity

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<sup>1</sup> The Company's reply is not intended to counter every claim made in the post-hearing memoranda of the intervenors because many issues and claims raised by the parties were known to the Company, and therefore, were comprehensively addressed in the Company's own post-hearing memoranda. Consequently, the Commission should not take silence on any issue to indicate agreement with claims raised in the post-hearing memoranda.

<sup>2</sup> Exh., NGRID-3 (Schedule NG-MDL-1, at 31-32).

<sup>3</sup> Id.

<sup>4</sup> Tr. 9/10/08, at 74-76.

actually used by National Grid plc (37.77 percent) in financing its global operations.<sup>5</sup> From the Company's perspective, the use of the UK parent company capital structure may conveniently (and arbitrarily) lower the cost of utility service for Rhode Island customers, but it will also ensure that the rates set by the Commission in this proceeding provide an insufficient level of return for National Grid's regulated gas distribution operations. This is an unacceptable result because gas distribution operations are inherently *capital intensive* and the Company cannot devote its capital resources to its Rhode Island regulated gas operations if the return that it is receiving through rates is effectively calculated to reflect the cost of financing *unregulated* activities that are undertaken by the parent company and may involve substantially less capital investment than a gas distribution operation. Yet, this is the effect of applying the Division's recommendation.

The record evidence demonstrates the arbitrary nature of the Division's recommendation, as follows:

First, the Division's thesis hinges on the premise that investors look no further than the aggregated results of the National Grid plc's operations to evaluate the sufficiency of the return associated with the regulated operations of any one subsidiary company. In fact, the record shows that investors will look at *each sector* of the UK parent company's operations to assess the applicable risk profile, which would include the Commission's decisions on capital structure and return on equity in relation to the Company's Rhode Island gas company.<sup>6</sup> The record further shows that ratings agencies and investors will not view a 37.77 percent equity ratio as appropriate for the Company's gas distribution operations in

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<sup>5</sup> Post Hearing Memorandum of the Division at 5. Yet, the Division ignores the cost of debt and cost of equity that is associated with the National Grid plc capital structure, which only underscores the arbitrary nature of the Division's "end-result" driven analysis.

<sup>6</sup> See, e.g., Exh. DIV-11 (Data Request 3-22, at "Global Credit Research Credit Opinion," dated February 1, 2008).

Rhode Island, nor as comparable with other peer companies in which investors could invest.<sup>7</sup> Contrary to the assertions of the Division's witness, the authorization of a rate of return that is insufficient to support gas distribution operations will have an impact not only in terms of the external ratings agencies and investors, but also in terms of the Company's ability to attract capital for use in Rhode Island *from the parent company*.

Second, the Division's witness admitted that he not researched, studied or even attempted to familiarize himself with the range of businesses the comprise the UK parent company operations. Yet, the net effect of using the UK parent company capital structure for ratesetting purposes in Rhode Island is to "borrow" from the risk profiles of the other regulated and unregulated businesses that are averaged into the UK capital structure. This approach introduces a cross-subsidy rather than having Rhode Island gas rates reflect its own costs. In that regard, there is no dispute in the record that the cost of money is a direct function of risk, so that the cost of financing any particular business entity will be a function of its risk profile.<sup>8</sup> However, the Division is effectively arguing that the risk profile of the UK parent company represents the risk profile of all of its component companies, whether regulated and unregulated or whether located in the U.S. or some other place, and that, consequently, the cost of financing each of those component entities is the same.

Based on this "logic," the Division posits that, if the Company's proxy capital structure is used to set rates (47% equity), Rhode Island customers would be "subsidizing the cost of the Company's unregulated businesses."<sup>9</sup> Yet, in fact, it may be just the opposite that is true, i.e., using the UK parent company capital structure to set rates in Rhode Island may

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<sup>7</sup> Exh. DIV-31; Exh. NGRID-9, at 3-6.

<sup>8</sup> Exhs. NGRID-8 and NGRID-9; Exhs. DIV-5 and DIV-6.

<sup>9</sup> Post-Hearing Memorandum of the Division, at 8.

result in an inordinately low return for the regulated gas operations, with the Company's unregulated operations subsidizing the cost of capital for the regulated operations. The Division's witness cannot substantiate his claim regarding the "subsidization" of other entities under the National Grid plc organization without an analysis of risk and capital costs. More importantly, without an analysis of the way in which the risk profiles and capital financing costs of the component entities are affecting the overall capital structure of National Grid plc, there is no basis for the Commission to determine that the use of the National Grid plc capital structure in setting rates for the gas distribution rates in Rhode Island is reasonable or appropriate. In this case, no record whatsoever exists to reach the conclusion that use of the National Grid plc capital structure is appropriate given these considerations, nor has the Division's witness attempted to support his arbitrary recommendation with such an analysis.

A third problem with the Division's recommendation is that it was made without any knowledge or understanding of the structure of rate regulation in the UK and the effect that these considerations would have on the cost of capital and capital structure recommendations. In its post-hearing memorandum, the Company discussed in detail that there is a different regulatory structure in the UK and that the regulator of National Grid's UK business does not utilize the capital structure represented by its U.S. Generally Accepted Accounting Principles ("GAAP") accounts when setting rates and that rates are set in the UK based on a Regulatory Asset Value ("RAV").<sup>10</sup> The Company further showed that (1) the equity component determined in accordance with US GAAP must be adjusted to recognize the difference between the RAV and the US GAAP book value of the UK regulated

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<sup>10</sup> Id. at 17-18; Tr. 9/10/08 at 10-11, 50-52.

businesses, and (2) the adjustment increases National Grid's consolidated common equity ratio determined in accordance with US GAAP by approximately eight percentage points.<sup>11</sup> As noted below, the resulting common equity ratio would be 52.19%, or well above the level proposed by the Company in this case.<sup>12</sup>

Significantly, the Division is unable to point to any record evidence contesting or contradicting this the need for this adjustment, or the accuracy of the Company's calculation. Instead, the Division simply asserts that this information [on the need to adjust for RAV] "provides 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."<sup>13</sup> The Division further states that:

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. 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. National Grid, PLC/s "resulting bond rating is fine and so with an A minus bond rating I don't see any reason why the company . . . should be expected to have pressure to increase its common equity ratio."<sup>14</sup>

It must be noted that this statement *does not prove or even assert that the RAV adjustment does not have to be made*. Rather, his statement appears to be that his assumption is that the RAV has been accounted for in the "application of GAAP standards and bond rating reports." Mr. Rothschild does not know this to be true, and he has presented no evidence tending to show that it is true. To the contrary, the record shows that (1) the adjustment must be made, and that (2) the bond ratings agencies make that adjustment in

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<sup>11</sup> Exh. NGRID-9, at 17-18.

<sup>12</sup> Id. at 18.

<sup>13</sup> Post-Hearing Memorandum of the Division, at 6.

<sup>14</sup> Id., at 8 (emphasis in original).



rendering their reports. Given that Mr. Rothschild was not aware of the RAV when making his recommendation, his unsupported assertion that it has already been accounted for in the Company's financial reports cannot be relied upon. In fact, the Commission cannot reasonably adopt the Division's recommendation of a 37.77% equity level on the basis of an uncontested record showing that an adjustment of eight percentage points is needed to recognize the difference between the RAV and the US GAAP book value of the UK regulated businesses.

Fourth, the record shows that, even if it were appropriate to look to National Grid plc for the capital structure, the Division's witness has not correctly stated the equity ratio for National Grid plc in accordance with U.S. GAAP.<sup>15</sup> The Company explained in its post-hearing memorandum the Division's witness failed to take into account approximately \$3.7 billion of cash, cash equivalents and marketable securities carried on its fiscal 2007 balance sheet in calculating its capital structure.<sup>16</sup> Notably, the Division's post-hearing memorandum *makes no mention of, or adjustment for*, this error. These cash balances should have been subtracted from outstanding debt balances to compute the capital structure ratios, but were not.<sup>17</sup> If this correction were made, the common equity ratio for National Grid plc would total **44.36** percent, and with the adjustment for the RAV of National Grid plc's regulated UK businesses, the actual common equity ratio that would apply to the Rhode Island operations would be **52.19** percent, rather than the 37.77% incorrectly calculated by the

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<sup>15</sup> Exh. NGRID-9, at 15.

<sup>16</sup> Id.

<sup>17</sup> Id., at 15-16.

Division's witness.<sup>18</sup> If the Commission were to put all else aside, this un-rebutted evidence is sufficient to invalidate the Division's recommendation of a 37.77 percent equity ratio.

Mr. Rothschild stated that he was "end result" driven and that he felt comfortable *without having analyzed* the components of National Grid plc's component businesses or differences in regulatory ratemaking and accounting principles that exist between the U.S. and U.K. systems. However, given the lack of analysis supporting the Division's recommendations and the calculation errors that are un-addressed by the Division, the adoption of the Division's recommendation of a 37.77 percent equity ratio would be an arbitrary result without foundation in the record. Moreover, even if the Commission were inclined to adopt Mr. Rothschild's recommendation on using the UK parent company capital structure, the record evidence dictates that the RAV and cash-balance corrections must be made, which results in a common equity ratio of 52.19 percent.

Accordingly, based on the foregoing, the Company believes that the weight of the record evidence shows that the reasonable and appropriate level of common equity to be used in the capital structure for the purposes of determining the rate of return is 47 percent, as recommended by the Company.

### **III. Return on Common Equity**

The Division's post-hearing memoranda places a large emphasis on "an important piece of evidence that came late in the proceeding," which is a powerpoint presentation and associated discussion given by National Grid's Chairman and Chief Operating Executive Officer to the investment community.<sup>19</sup> In particular, the Division references the phrase

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<sup>18</sup> Id., at 16-18.

<sup>19</sup> Division at 3; Exh. DIV-69, at 6; Exh. DIV-70.

“[w]e are a very low risk business”<sup>20</sup> as establishing that National Grid is an “‘extraordinarily low risk’ company with very solid returns.”<sup>21</sup>

These exhibits are significant additions to the record, but not for the reasons cited by the Division. The Division relies on these exhibits as support for its premise that the Company’s calculation of a reasonable return on equity of 11.5 percent is unreasonable and “inaccurate.”<sup>22</sup> However, the Division is able to reach this conclusion only by treating the exhibits as completely unrelated to market events. In fact, the document only serves to underscore the statements made by Mr. Stavropoulos on the meltdown of the financial markets in which the Company *must* seek capital to fund day-to-day operations. In particular, Mr. Stavropoulos testified that:

[E]verything I’ve read in the financial press and from the analysts’ reports, issued recently about our industry and about our company in general, certainly suggests very strongly that the cost of equity capital has gone up as a result of the recent financial meltdown or financial crisis. It makes sense because what we’ve seen is a large jump in the premium for debt capital over the risk free rate. So wherever that risk free rate happens to be, there’s been, I think unarguably, a very large increase in the risk premium for – even for creditworthy accounts. And then with the volatility in the market, all companies’ betas of their common stock have gone up. With a higher beta, that translates directly into higher risk. Higher risk demands a higher rate of return. . . . [s]o analysts are suggesting that the current financial crisis has led to probably a 50- to 100-basis point increase in the cost of equity capital.<sup>23</sup>

Although the Division may be unaware of the challenges facing the Company in attracting sufficient, low-cost capital in this market, Exhibits DIV-69, DIV-70 and DIV-71 cannot be taken in isolation of the market context in which they were delivered. As acknowledged by the Division, these exhibits are materials prepared by National Grid plc for

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<sup>20</sup> Id.

<sup>21</sup> Exh. DIV-70.

<sup>22</sup> Post-Hearing Memorandum of the Division, at 3.

<sup>23</sup> Tr. 10/22/08, at 21-22.

presentation to investors to “portray 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.”<sup>24</sup>

The Company does not disagree with this characterization: these materials were prepared and delivered to materials in October 2008, in the height of the market uncertainty and were intended to assure investors that National Grid plc is low risk compared to other investments currently available in the marketplace.<sup>25</sup> Although overlooked by the Division, the Company testified that other investments available in the marketplace include junk bonds, mortgage-backed securities, derivatives, CDOs, commercial paper, small cap stocks, international stocks, emerging market stocks and commodities.<sup>26</sup> As a result, there is no debate from the Company that the nature of its operations are “extraordinarily low risk” when compared to the range of investments available in the marketplace.

The Division also cites to these materials in relation to capital structure, referencing a statement that is quoted in the Division’s post-hearing memorandum, but taken completely out of context in terms of having probative value for the Commission’s determination on the appropriate capital structure for the gas distribution business in Rhode Island. Specifically, the Division cites to a quote from National Grid plc CEO, Steve Holliday, discussing the global businesses. The partial quote was: “We only invest when we can lock in a return over our cost of capital.” Putting aside the fact that this statement is hearsay and not “evidence” to support an imputed capital structure, the statement is intended only to obfuscate the issues.

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<sup>24</sup> Post-Hearing Memorandum of the Division, at 3.

<sup>25</sup> Tr. 10/22/08, at 71.

<sup>26</sup> Tr. 10/22/08, at 87-88.

In context, the full quote from an interview with an investor analyst, discussing National Grid plc, was as follows:

Q. In terms of the growth story tell me more about your investment strategy?

A. Well as I mentioned we're investing £3bn this year after investing £3.1bn last year. Those investment levels will continue as far as we can see; certainly out to 2012. We're looking at the moment at the investments that will be required both in the UK and in the US as we address the combined issue of how do we green up our energy mix; for us how do we tie in new sources of power in particular and bring new sources of gas into the markets and how do we renew old infrastructure that needs renewing. Those twin challenges of green and energy security mean that we're going to be investing substantial sums as far into the future as you can see.

Q. What kind of guarantees do you have on the return on those investments? What are the risks involved?

A. We only invest when we know we can lock in a return over our cost of capital. Again, that's the thesis, that's the model of National Grid. That's why we are safe and we're growing. So all of those investments will be made when we've either reached a regulatory agreement in the UK or the US with our regulators to guarantee a return on that investment, or in the places where we are in an unregulated environment, we've signed a long-term contract with people to buy the capacity of that piece of pipe, or that LNG facility etc. So we're always locking in our returns.

Rather than representing the off-handed remark presented by the Division, it is clear from the entire excerpt that Mr. Holliday was discussing the massive commitments the global business has been making in a multitude of places. Moreover, this quote was about National Grid's global business, comprising both regulated and unregulated activities in both the UK and the US. As with other materials developed for presentation to potential investors, the interviewer was seeking assurance that the returns on those massive investments will be reasonable. Mr. Holliday, speaking informally, made broad statements about the Company's overall global investment strategy and its intention to obtain appropriate returns through regulatory agreements before embarking on such massive programs. To use this statement in

this rate case for the purpose of suggesting that the Commission should now impose an artificially low equity ratio of 37.77% and a return on equity of less than 10% (which would be below the gas distribution industry average) is out of place and inappropriate.

In fact, as the Chairman and Chief Executive Officer of a company that owns significant regulated utility operations, Mr. Holliday *has an obligation* to reach out to investors and to educate and assure investors of the “conservative nature” of the Company’s operations, as well as the relative level of safety in making an investment in National Grid plc. This is because the Company’s cost of capital and *access to capital* may be affected by a lack of confidence by market investors. This can only have the affect of *increasing costs* to the customers of the regulated utility operations and jeopardizing the Company’s ability to carry out its public service obligations.

This is true even in relation to other public utility holding companies. Mr. Stavropoulos testified that the Company is competing for capital with other public utility companies that may be involved in activities that carry a far greater risk than the business activities undertaken by National Grid.<sup>27</sup> For example, Mr. Stavropoulos referenced the situation with Constellation Energy, which was forced to sell its operations to Warren Buffet because they conducted relatively significant commodity trading business, which negatively affected the financial health of the company.<sup>28</sup> This is the reason that the exercise in a distribution rate proceeding is to evaluate the cost of common equity for comparable regulated utilities. In this case, the Company has performed this analysis and, based on the proxy group, derived a recommended cost of common equity of 11.5 percent, which the record shows does not take into account the most recent market events.

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<sup>27</sup> Tr. 10/22/08, at 71.

<sup>28</sup> Id.

There are several other points made in the Division's discussion of ROE that must be addressed. These items are as follows:

First, the Division makes the statement that the Company is "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%."<sup>29</sup> This statement is incorrect.<sup>30</sup> The record shows that the average historical return of the market from 1926 to 2007 is 12.3 percent.<sup>31</sup>

Second, in its post-hearing memorandum, the Division has failed to address the numerous errors in Mr. Rothschild's analysis of his recommended return on equity in this proceeding. Most significantly, the Division has not addressed the central flaw of Mr. Rothschild's DCF analysis, which is a downward bias resulting from the selection of the second lowest value in Exhibit DIV-5, Schedule JAR-3, fn.A (presenting historical return on book common equity). The record shows that, if Mr. Rothschild had objectively selected the average, median, or midpoint values from his range of inputs, his DCF result would increase to 10.25 percent, or 10.03 percent, or 10.68 percent, respectively<sup>32</sup> Moreover, a more conventional DCF analysis for the proxy group would provide an 11.32% return.<sup>33</sup> As a result, the result of the Division's DCF analysis is unreasonably low.

Lastly, the Division asserts that the Company's DCF methodology is flawed in a number of ways. Each of these alleged deficiencies is addressed below:

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<sup>29</sup> Division at 3.  
<sup>30</sup> Tr. 9/10/08, at 74.  
<sup>31</sup> Exh. NGRID-9, at 33.  
<sup>32</sup> (Moul Rebuttal page 24)  
<sup>33</sup> (see Moul Rebuttal page 28).

1. *The Division claims that incorrectly relies on forecasts of earnings-per-share growth as a proxy for long-term sustainable growth.*<sup>34</sup> However, the record shows that earnings-per-share is the proper input because it properly reflects investor expectations on capital gains yield and the source of dividend payments.<sup>35</sup> The record also shows that Professor Gordon, the foremost proponent of the DCF model in rate cases (and the individual whose name is most commonly associated with the DCF model), has determined that the best measure of growth in the DCF model is analysts' forecasted earnings per share growth.<sup>36</sup> Further, with the forecast decline in dividend payout ratios, analysts' earnings growth forecasts must be emphasized.<sup>37</sup> Therefore, earnings per share forecasts must be given primary weight in the DCF analysis.

2. *The Division claims that the Company's "leverage adjustment" goes against basic finance principles and that Mr. Moul's growth rate is not reflective of the long-term sustainable growth required by the constant growth form of the DCF analysis.*<sup>38</sup> This is not accurate. In fact, the record shows that the leverage adjustment is needed in the ratesetting context because the market value of the equity component of the proxy group's market capitalization was much higher than its book value capitalization. The adjustment considers both the market value of debt and equity.<sup>39</sup> In other words, the market value common equity ratio was 68.29 percent compared to a book value common equity ratio of 54.44 percent.<sup>40</sup> To make the market-derived DCF results applicable in the ratesetting context, it is necessary

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<sup>34</sup> Division at 13.

<sup>35</sup> Exh. NGRID-9, at 27.

<sup>36</sup> Id., citing, "Choice Among Methods of Estimating Share Yield," The Journal of Portfolio Management, Spring 1989 by Gordon, Gordon & Gould."

<sup>37</sup> (see Moul Rebuttal page 26).

<sup>38</sup> Division at 13.

<sup>39</sup> Exh. NGRID-9, at 29-30; Tr. 9/10/08, at 30; (see Attachment NG-PRM-5 pages 12 and 13)

<sup>40</sup> Exh. NGRID-9 (Attachment NG-PRM-5, at 13-14).



to account for the higher financial risk that arises from the lower common equity ratio measured by book value capitalization as compared to the higher common equity ratio measured by market capitalization.<sup>41</sup> Because book value capital structures are used to set rates, the adjustment procedure is required.<sup>42</sup> In addition, the record shows that “sustainable growth” does not work with declining payout ratios.<sup>43</sup>

3. *The Division claims that Mr. Moul’s equity risk premium method “inappropriately assumes” that equity risk premiums are constant when, in fact, they have actually been decreasing over time.*<sup>44</sup> This is not accurate. Mr. Moul never stated that equity risk premiums are constant.

4. *The Division claims that Mr. Moul incorrectly used the arithmetic mean instead of the geometric mean in calculating the premium of S&P Utility Index over public utility bonds.*<sup>45</sup> This is not accurate. The arithmetic mean provides an unbiased estimate, provides the correct representation of all probable outcomes and has a measurable variance.<sup>46</sup> According to Ibbotson the expected equity risk premium should always be calculated using the arithmetic mean.<sup>47</sup>

5. *The Division claims that Mr. Moul’s CAPM analysis uses 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.*<sup>48</sup> A

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<sup>41</sup> Id.

<sup>42</sup> Id.

<sup>43</sup> Exh. NGRID-9, at 26.

<sup>44</sup> Post-Hearing Memorandum of the Division, at 14.

<sup>45</sup> Id.

<sup>46</sup> Exh. NGRID-9, at 32-33.

<sup>47</sup> Id.

<sup>48</sup> Post-Hearing Memorandum of the Division, at 14.

comprehensive analysis of the Value Line data shows that the five-year projected total return is entirely reasonable. As shown by the 16.5% percent retained to common equity for the Value Line composite, which represents Mr. Rothschild's preferred measure of the DCF growth rate, the Value Line 10.67% median appreciation potential is reasonable, albeit conservation.<sup>49</sup>

In its post-hearing memorandum, the Division concludes that its recommended cost of capital is a "reasonable, well-researched and well thought out result that "deserves" to be adopted by the Commission.<sup>50</sup> However, the Commission does not have the latitude to adopt recommendations because they "deserve" to be adopted. Similarly, the Division asserts that the Company's "admission" that National Grid is a "low risk" company, coupled with the "economic crisis facing Rhode Island "mitigates" in favor of its lower ROE recommendation.<sup>51</sup> The Company does not underestimate the difficulties that Rhode Island customers are facing in this economic crisis; the Company confronts it every day in its operations. However, the economic crisis also is having an effect on the Company's cost of capital, which is a factor that is completely unaccounted for in Mr. Rothschild's analysis (see Moul Rebuttal page 6).

In that regard, the record evidence shows that Mr. Rothschild's DCF analysis contains an inherent downward bias, which produces a result that is significantly lower than the rates of return approved for gas and electric utilities *prior to the changes in investment risk arising from prevailing market conditions*. The record is clear that, to obtain new capital and retain existing capital, the rate of return on common equity for the Company's regulated gas

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<sup>49</sup> Exh. NGRID-9, at 34 (Attachment NG-PRM-9, at 4).

<sup>50</sup> Post-Hearing Memorandum of the Division, at 17.

<sup>51</sup> Post-Hearing Memorandum of the Division, at 18.

distribution operations in Rhode Island must be high enough to satisfy investors' requirements and that, in this market, investors are seeking assurance that (1) their investment is safe, and (2) they will have the opportunity to realize a return that reflects their level of risk in this market. The recommendation of Mr. Rothschild, which proposes an equity return of 9.50 percent relative to a 47.71 percent common equity ratio (or 9.95 percent relative to a 37.77 common equity ratio), does not meet this threshold and would send a negative signal of regulatory support in Rhode Island.<sup>52</sup>

#### **IV. Return on Equity Decoupling**

In terms of the Division's recommended ROE adjustment for the decoupling provision, the record shows that the Division's arguments are misguided and avoid important record evidence.

As an initial matter, the Company's witness tested the premise of Mr. Rothschild's position by determining whether investors change their return requirements as a result of decoupling – no such analysis was provided by Mr. Rothschild of his own recommendation.<sup>53</sup> The Division attempts to argue that because some of the companies included in that analysis had decoupling mechanisms implemented in multiple jurisdictions, the result is somehow “diluted” such that it would be “impossible” to quantify the pre- and post-implementation cost of equity. The Division fails to recognize, however, that even companies that operate in a single jurisdiction did not see a reduction in the cost of equity upon the implementation of decoupling mechanisms.<sup>54</sup> Thus the Division's argument in that regard has no foundation in the record.

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<sup>52</sup> Exh. NGRID-9, at 3-6.

<sup>53</sup> Exh NGRID-12, at 3.

<sup>54</sup> Exh NGRID-12, at 23.

The Division further argues that Mr. Hevert's analysis was not "precise" enough to distinguish among decoupling announcement, order and implementation dates.<sup>55</sup> When asked on cross examination whether the definition of the event date would change the results of his analysis, the Company's witness testified that difference in the event date would not have made a difference.<sup>56</sup> In fact, at hearing Mr. Hevert offered to perform that analysis and when asked by the Chairman if the Division wanted Mr. Hevert to do so, the Division declined.<sup>57</sup> Yet, inexplicably, the Division now criticizes the Company's analysis as lacking "precision" when it declined the Company's offer to revise its analysis in response to that concern.

The Division also argues that Value Line calculates Beta coefficients over a five year period, which is far too long to capture the effect of an event that may have occurred over a 180 day period.<sup>58</sup> However, the Company's witness testified, if Mr. Rothschild's theory is correct, the Beta of a company that implements decoupling mechanisms would fall to a level that is very low, and near zero.<sup>59</sup> Mr. Hevert further testified that under Mr. Rothschild's theory, the Beta of a company that implements decoupling would fall substantially and be materially below the lowest Beta estimate of Mr. Rothschild's proxy group, which was .80.<sup>60</sup> Mr. Rothschild, however, testified that the Beta of corporate bonds are "materially higher than zero."<sup>61</sup> Mr. Rothschild further testified that such an analysis is "not that hard of a computation to make", yet the Division did not provide any such computation in its brief.

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<sup>55</sup> Post-Hearing Memorandum of the Division of Public Utilities and Carries, at 16.

<sup>56</sup> Tr. 9/10/08, at 122.

<sup>57</sup> Tr. 9/10/08, at 123.

<sup>58</sup> Post-Hearing Memorandum of the Division of Public Utilities and Carries, at 17.

<sup>59</sup> Tr. 9/10/08, at 132.

<sup>60</sup> Tr. 9/10/08, at 132, Exh NGRID-12, at 31

<sup>61</sup> Tr. 9/10/08, at 177.

The Company, however, did make that computation. In RR-COMM-18, the Company first provided several citations, including text books, academic articles and regulatory precedent, all of which clearly support the Company's position that debt betas are at or near zero.<sup>62</sup> In addition, using Mr. Rothschild's own data the Company calculated that the debt beta is between .06 and .08<sup>63</sup>; it is not "materially higher" than zero as Mr. Rothschild testified. Thus the Division's argument is entirely misplaced.

Finally, the Division never addressed the uncontested fact that no company that has implemented a decoupling mechanism has seen a rating increase as a result of that mechanism. Nor did the Division reconcile Mr. Rothschild's extreme position with the vast majority of regulatory decisions that resulted in no adjustment to the ROE in connection with a decoupling mechanism. In fact, the Division has never advanced a single argument or basis that provides any rationale, either empirical or quantitative, in support of Mr. Rothschild's arbitrary 75 basis point adjustment. Thus the Division's recommendation should be given no weight in the determination of the Company's ROE.

## **V. Return on Rate Base**

The Division recommends that the total plant-in-service as of the end of the rate year should be reduced by \$10,259,000.<sup>64</sup> If adopted by the Commission, this adjustment would reduce the annual revenue requirement by \$626,000.<sup>65</sup> The Division claims that this adjustment should be made because the actual rate of capital additions subject to March 2008

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<sup>62</sup> RR-COMM-18.

<sup>63</sup> Id.

<sup>64</sup> Post-Hearing Memorandum of the Division, at 19.

<sup>65</sup> Id.

has “continued to fall well short of the Company’s forecasts.”<sup>66</sup> The Company addressed this issue in detail in its Post-Hearing Memorandum and will not repeat its arguments here.

However, it should be noted that Division’s comments in its Post-Hearing Memorandum make no mention of the testimony by Susan Fleck, which goes to the fundamental premise of the Division’s recommendation. Specifically, the Division’s position depends on a “linear” amount of monthly spending through the fiscal year end meaning that the Division has concluded that, if spending is “behind” at one point during the fiscal year, it will be behind at the end of the fiscal year. This is not a correct assumption, nor one that is supported by the record. In fact, Ms. Fleck testified that there was a lag in contractor billing (capital spending is recorded when contractor bills are received) and a need to ramp-up construction activities, which caused 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.<sup>67</sup> The witness also testified that the Company would achieve the forecasted amount of capital spending by the end of the year and there is no evidence contradicting this testimony or establishing that there is some reason that the Company will not achieve this level.<sup>68</sup>

The Division’s recommended disallowance is based solely on the premise that “under budget” spending levels through July 2008 are indicative of under-budget spending through the end of the rate year. In light of Ms. Fleck’s testimony that spending levels have and will increase, the Company should not be penalized for a non-linear spending pattern when it is making needed capital improvements, which is the effect of the Division’s recommended disallowance. Nor would the Company object to an adjustment in the rate-year end plant-in-

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<sup>66</sup> Id. at 20.

<sup>67</sup> Tr. 9/9/08, at 9-10.

<sup>68</sup> Id.

service amount if, in fact, the capital spending does not occur. Therefore, the Company suggests that it could update its response to Data Requests DIV-1-2 and DIV-13-4 to provide the capital spending in the months August 2008 through October 2008, which would demonstrate that spending levels are increasing and narrowing the gap in budgeted and actual spending, consistent with Ms. Fleck's testimony.

## **VI. Non-Firm Rates**

In this proceeding, the Company has a fundamental question pending before it on the structure of non-firm rates. The Company will not repeat all of its arguments here. However, based on the post-hearing memoranda of the parties, it appears that there are at least two recommendations posed for the Commission. The first is recommended by Rhode Island Hospital and TEC-RI, which both propose that non-firm rates be fixed at a 40 percent discount to firm rates.<sup>69</sup> The second is the Company's proposal, which is to maintain the value of pricing rate structure subject to a cap.<sup>70</sup> Although other parties have commented on the non-firm pricing issue, it does not appear to the Company that any other specific recommendations on pricing were submitted to the Commission.

At this point, the Commission is well versed on the nuances and trade-offs of the non-firm pricing issue. However, in considering the pros and cons of the two recommendations pending before the Commission, the Company would like to state the following:

1. The Commission should adopt a non-firm rate structure that is consistent with the true nature of non-firm service. The basic reality of non-firm service is that, with the exception of a few customers who are located in capacity constrained areas of the system, *it*

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<sup>69</sup> Initial Brief of Rhode Island Hospital at 15; TEC-RI, at 9.

<sup>70</sup> Post-Hearing Memorandum of National Grid, at 84.

*is the customer's choice, and not the Company's choice, to take non-firm service.*<sup>71</sup> As Mr. Stavropoulos testified, non-firm customers want to have the ability to “opt in and opt out” at any time without a firm commitment.<sup>72</sup> The statement has been made a number of times that, the Company's non-firm customers receive service *only* if there is excess capacity on the system and that when the Company performs its system planning and investment studies, it excludes the load of non-firm customers.<sup>73</sup> This perspective makes it seem as though it is highly inequitable to charge non-firm customers anything but a significantly discounted rate. However, while it is true that non-firm customers use the Company's capacity only when there is excess available and that they are excluded from the load planning process, it is only because those customers are unwilling to make a firm commitment to the system and have, therefore, *self-selected* to be shut off rather than paying a demand charge (with the exception of the 12 non-firm customers who are located in capacity-constrained areas).

For the Company, this point is important, because non-firm customers receive a significant benefit in having the system's capacity available to them on an “on-call” or standby basis so that they can use it when it is to their economic advantage to do so, while at the same time avoiding demand charges associated with firm service. In this regard, non-firm customers do not receive a lesser level of service; they receive the service for which they have contracted and the service that offers them the “optionality” that they desire to meet their budgetary or business needs.<sup>74</sup>

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<sup>71</sup> Tr. 10/22/08, at 19-20.

<sup>72</sup> Id.

<sup>73</sup> See, RPost-Hearing Memorandum of Rhode Island Hospital at 4.

<sup>74</sup> See, Tr. 9/08/08, at 28 (Testimony of Mr. Christopher Powell, Brown University on the reasons that the University continues to burn No. 6 fuel oil).



This point is also important in terms of the Commission’s policy decision because the recommendation is to provide non-firm service at a significant fixed discount, on the basis that the service is a lesser quality than the service afforded non-firm customers. However, the Commission’s pricing policies should recognize that there is a significant benefit to these customers in keeping their options open and yet having the ability to rely on the reliability of the gas system when it is to their benefit. Thus, the non-firm rate price needs to be fair to firm service customers also who do not have the ability to choose or avoid costs and are subject to the demand charges inherent in their distribution rate. The Company does not agree that a fixed 40% discount achieves this balance.

2. The Commission’s Pricing Policy Should Encourage Firm Service in All Cases Where the Dual-Fuel Customer’s Alternative Fuel is “Non-Competitive.”

In addition, the non-firm rate should be structured so as to provide an incentive for dual-fuel customers to take firm service when the cost of their alternative fuel option is “non-competitive,” with natural gas. The only reason that non-firm service is available to dual-fuel customers is because those customers have the ability to purchase their energy service somewhere else and avoid using the gas distribution system altogether. Because the system benefits from throughput, it makes sense for the Company to offer non-firm service to these customers in order to obtain throughput volumes that would not otherwise be available. However, if there is *no possibility* that the system would lose the throughput (because the non-firm customer’s alternative fuel is so highly priced as to be “non-competitive”), then there is no reason for the Company to extend a discounted price – the customer should be on firm service if the capacity is available. Otherwise, what makes the dual-fuel customer “special”? Why wouldn’t all firm C&I customers “deserve” the same discount? A fixed, discounted rate will effectively provide preferential treatment to dual-fuel customers,

although they have no intention of using their alternative fuel because of the economics in the marketplace. This is inherently unfair to existing firm customers.

3. The Company Has Sufficient Capacity to Serve the Bulk of the Dual-Fuel Customers Existing on the System.

Much has been made out of the fact that there exists on a number of customers on the system who may like to take firm service, but are unable to do so. However, the record shows that a significant number of non-firm customers are currently taking firm service *without the need for any system upgrades*<sup>75</sup>. The record also shows that one of the primary reasons that non-firm customers are shut off is to ensure that the system does not incur incremental costs in peak periods to support non-firm load, and not because of a lack of distribution capacity.<sup>76</sup> Thus, while there are approximately 67 dual-fuel customers on the system, only 12 of those customers are located in capacity constrained areas.<sup>77</sup> Those customers with constraints can be handled with special contracts that reflect the specific limitations to the service, i.e. the specific temperature at which curtailment is necessary such as the Company proposed to do with Flex Firm service. Thus, where the capacity exists, the Commission's policies should encourage firm service.

4. The Record Shows that VOS Pricing Subject to a Rate Cap Would Provide Significant Relief to Non-Firm Customers

The record in this proceeding shows that a change in Commission policy applying a rate cap to the VOS pricing structure will substantially address the concerns of non-firm customers and will represent a significant improvement over the current structure for those customers.

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<sup>75</sup> RR-DIV-6, RR-DIV-8, RR-DIV-9.

<sup>76</sup> Id.

<sup>77</sup> Exh. DIV-15 (Data Request DIV 6-24).

For example, Mr. DiMetro, who was the witness offered by Rhode Island Hospital, had to concede that non-firm pricing was a Commission "judgment call" and that the Upstate New York method would be a reasonable method:

Q. My question for you in referring to that is given the hypothetical that I posed, let's say the Commission has that dilemma, too high and too low, would you agree with me that if the Commission was looking for a reasonable compromise between the company's proposal in this case and the hospital's proposal, the non-firm arrangement in Upstate New York would provide a reasonable solution?

A. If -- if what you're saying, if what you define as reasonable is if a discount is 40 percent versus the premium is 50 percent, if that's sort of in the middle, then that is one option, obviously, for the Commission. It's -- the primary problem has -- well, a couple problems with the existing structure. Obviously, it's been that there's been no cap, and therefore, it's been very difficult for customers to anticipate and plan their energy purchases and control their energy costs. When you institute a cap, that makes it easier to do. Now, whether the cap should be 100 percent of the firm rate or some discount to the firm rate, that's really a judgment call. But that still -- again, it still maintains the value of service pricing versus going with a price that's more known for the non-firm customer. Again, if the Commission were to stay with value of service pricing, if that was the decision, then certainly a cap would be necessary. **It's certainly reasonable to have the cap at a firm rate.** It's also reasonable to have it at some discount to the firm rate.<sup>78</sup>

Because the VOS pricing model would maintain the Company's ability to provide a discount to a non-firm customer's alternative fuel source in the event that market prices for the alternative fuel are lower than natural gas, the Company suggests that the Commission's adoption of a rate cap in concert with the VOS pricing structure would be a reasonable result for all parties in this proceeding.

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Tr. 10/23/08, at 23-24 (emphasis added).