

**STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION**

IN RE: FUEL ADJUSTMENT FACTOR TARIFF
FILING BY NARRAGANSETT ELECTRIC DOCKET NO. 3969
D/B/A NATIONAL GRID REVIEW OF
SETTLEMENT AGREEMENT

REPORT AND ORDER

I. Overview

The Utility Restructuring Act of 1996 (“URA”) required each electric distribution company to arrange with wholesale power suppliers for a standard offer power supply (“SOS”) to sell electricity to all customers. Pursuant to the URA, Narragansett Electric Company d/b/a National Grid (“NGrid” or “Company”) entered into wholesale Standard Offer Supply Agreements (“WSOSAs” or “contracts”) with several wholesale power suppliers, including Constellation Energy Commodities Group, Inc. (“Constellation”). NGrid and Constellation are parties to four WSOSAs, two in the former Narragansett zone and two in the former Eastern Utilities Association (“EUA”) zone. The WSOSAs include a stipulated base price per kilowatt-hour (“kWh”). Prior to 2005 the EUA contracts also provided for increases in the price per kWh of wholesale power supplied to NGrid in the event fuel prices increase above certain levels. The instant docket arose out of a dispute between Constellation and NGrid over whether a fuel adjustment factor (“FAF”) was required to be applied to the base amount for the period 2005 through 2009 under those EUA contracts.¹

¹ Beginning in 2002, NGrid represented to the Commission that under its reading of its WSOSAs, the fuel adjustment factor contained in the EUA zone WSOSAs expired on December 31, 2004. *See* Commission Order Nos. 17495 (issued May 30, 2003), 17972 (issued July 26, 2004), 18151 (issued February 17, 2005), 18473 (issued December 14, 2005) and 18509 (issued January 24, 2006). Another supplier, TransCanada, challenged this interpretation with NGrid and eventually filed an action in federal court. NGrid had been making protest payments to that supplier since early 2004. *See* Commission Orders 18151 (issued

In a Massachusetts court action, filed on April 14, 2008, Constellation claimed that it is owed FAF payments. (“FAF Action”)² Subsequently, in this docket, NGrid filed with the Commission for approval of a formula to calculate a FAF relative to the two Constellation WSOSAs in the former EUA zone for effect August 1, 2008.³ Discovery ensued in that matter and on September 2, 2008, NGrid filed a Settlement Agreement between NGrid, Constellation and the Division of Public Utilities and Carriers (“Division”) to resolve the FAF dispute and an additional dispute between NGrid, Constellation and the Division regarding the interpretation of certain provisions related to capacity payments contained in the WSOSAs and two additional Power Supply Agreements (“PSAs”) to which NGrid and Constellation are parties.⁴

Under the terms of the Settlement, NGrid will make a lump sum payment of \$20,000,000 to Constellation within ten (10) days of the Effective Date of the Settlement. NGrid and Constellation will amend the pricing and payment provisions of the two WSOSAs in the former EUA zone by adding a monthly contract reservation charge to be paid on the last business day of each month, beginning January 30, 2009 and ending December 31, 2009. The total combined monthly contract reservation charge will be \$2,516,164.00. The Settlement and related amendments to the WSOSAs are conditioned

February 17, 2005), 18473 (issued December 14, 2005) and 18509 (issued January 24, 2006) and associated Testimony of Michael Hager.

² Joint Ex. 1 (Motion to Approve Settlement Agreement), p. 2.

³ Fuel Adjustment Factor Tariff Filing, dated June 30, 2008.

⁴ Joint Ex. 1 (Settlement Agreement dated 8/29/08). NGrid filed a declaratory judgment action against Constellation in the U.S. District Court for the District of Rhode Island asserting that it was not required to make such capacity payments to Constellation under the terms of its contracts and pursuant to a decision rendered by the Federal Energy Regulatory Commission. (“UCAP Action” or “FCM Action”) NGrid Ex. 1, pp. 6-7.

on an approval by the Commission that permits NGrid to recover the costs of the Settlement through rates.⁵

The total ratepayer liability to be collected through the SOS charge, excluding any applicable interest allowed by the Commission, would be approximately \$50.2 million.⁶ The parties maintained that the Settlement is in the best interest of Rhode Island's ratepayers taking service under NGrid's SOS rate because it eliminates potential significant liability and the risks of litigation.⁷ According to data received into evidence, the potential liability to ratepayers if Constellation was successful in both litigated matters, could range between \$296 million and \$400 million.⁸

II. Pre-Filed Testimony

On September 8, 2008, NGrid submitted the Pre-Filed Direct Testimony of Ronald T. Gerwatowski, Deputy General Counsel for National Grid USA Service Company, in support of the Settlement. First, Mr. Gerwatowski explained that in the FAF Action, Constellation claimed that NGrid breached the WSOSAs and the implied covenant of good faith and fair dealing by not seeking a FAF in its rate filings with the Commission and by not making those FAF payments to Constellation.⁹ Mr. Gerwatowski indicated that Constellation's claim is similar to a claim made by TransCanada, another wholesale power supplier in the former EUA zone. He noted that in litigation with TransCanada, the court agreed that TransCanada was entitled to FAF

⁵ Joint Ex. 1 (Settlement Agreement), pp. 2-3, NGrid Ex. 1 (Redacted Pre-Filed Testimony of Ronald T. Gerwatowski), p. 9.

⁶ PUC Ex. 1 (NGrid's Response to PUC DR 1-11).

⁷ Joint Ex. 1, (Motion to Approve Settlement Agreement) pp. 3-4.

⁸ PUC Ex. 2 (NGrid's Responses to PUC DRs 2-1, 2-5), PUC Ex. 3 (Division's Responses to PUC DRs 1 and 7), PUC Ex. 4 (PUC DRs 1 and 2).

⁹ NGrid Ex. 1, p. 4

payments after 2004. He noted that in its court filings, Constellation claimed that the TransCanada litigation and the FAF action involve identical issues.¹⁰

Addressing the dispute regarding capacity payments, Mr. Gerwatowski stated that the capacity dispute relates to Constellation's claim that it is entitled to additional compensation from NGrid for the cost of providing electricity reserves known as unforced capacity pursuant to the WSOSAs and PSAs.¹¹ He indicated that this dispute arose following approval by FERC of a settlement that developed a fixed rate schedule for payments Generators would receive in New England in the forward capacity market during a "Transition Period." ("FERC Settlement").¹² According to NGrid and the Division, the FERC settlement "also contained a provision...[that] assigned cost responsibility to all Rhode Island Standard Offer Suppliers (including Constellation), through the end of the contracts."¹³ Constellation asserted that it was entitled to have its contract pricing adjusted on the basis that the FERC Settlement was a market change under the terms of the supply contracts. Constellation claimed that it was not bound by the FERC Settlement because it was not a signatory.¹⁴ NGrid filed a declaratory judgment action in Rhode Island federal court seeking a ruling that the FERC Settlement did apply to Constellation and therefore, Constellation was precluded from its claim for a pricing adjustment.¹⁵ Mr. Gerwatowski also provided NGrid's rationale for entering into the Settlement when the Company believes it has solid defenses to both of Constellation's claims.

¹⁰ *Id.* at 4-5.

¹¹ *Id.* at 6.

¹² *Id.*

¹³ *Id.* at 6-7.

¹⁴ *Id.* at 7-8.

¹⁵ *Id.* at 7.

III. Hearing

Pursuant to a Notice of Hearing published in the Providence Journal, a public hearing was held at the Commission's offices, 89 Jefferson Boulevard, Warwick, Rhode Island, on September 22, 2008 to consider the Settlement Agreement.¹⁶ The following appearances were entered:

FOR NATIONAL GRID:	Gerald J. Petros, Esq. Hinkley, Allen, Snyder, LLP
	Brent R. Canning, Esq. Hinkley, Allen, Snyder, LLP
	Thomas Teehan, Esq.
FOR DIVISION:	Paul J. Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Cynthia G. Wilson-Frias, Esq. Senior Legal Counsel

NGrid presented Mr. Gerwatowski in support of the Settlement. The Company also presented Ms. Jeanne Lloyd, Manager of Rates Electric Distribution and Pricing for National Grid Service Company, and Mr. John Warshaw, Principal Analyst for National Grid, to respond to Commission inquiry. Mr. Gerwatowski explained that the Settlement will conclude two contentious lawsuits, the outcome of which could have potential liability that he referred to as "staggering amounts depending on how you evaluate the case."¹⁷ He indicated that while the potential liability under the two lawsuits is a moving number, the high end of the range could be \$300 million, an amount that was "most

¹⁶ After considering oral arguments regarding requests for privilege under Commission Rules of Practice and Procedure 1.2(g), the Commission determined that the documents submitted under seal were exempt from release pursuant to the Access to Public Records Act, R.I. Gen. Laws § 38-2-2(A)(II)(B) (trade secrets and commercial or financial information obtained from a person, firm or corporation which is of a privileged or confidential nature) and R.I. Gen. Laws § 38-2-2(A)(II)(E) (any records which would not be available by law or rule of court to an opposing party in litigation).

¹⁷ Tr. 9/22/08, p. 20.

disconcerting for us as we try to protect customers from increasing standard offer rates.”¹⁸

Mr. Gerwatowski noted that one of NGrid’s concerns regarding litigation uncertainty arose from a prior dispute between the Company and another supplier regarding FAF payments. He indicated that the judge in that case reviewed identical language as what is contained in the two Constellation WSOSAs and determined that FAF payments were due to the supplier from 2005 through 2009. Therefore, NGrid was concerned that the “judge may already be predisposed to provide a similar finding in Constellation’s favor.”¹⁹ However, he also testified that the supplier in the first matter demanded FAF payments in the first quarter of 2005, whereas Constellation did not bill NGrid for FAF payments until April 2008, noting that “in fact, [prior to April 2008] invoices that we received had a line for fuel index payments and they stated zero.”²⁰ He stated that because the Company received a claim from only one supplier in 2005, NGrid believed the other suppliers concurred with its reading of its WSOSAs and, therefore, there was no reason to contact the other suppliers to ensure compliance.²¹ Mr. Gerwatowski stated, “[w]e felt adamant that fuel index payments were not owed to Constellation.”²²

In response to a Commission inquiry as to why ratepayers should have to pay 100 percent of the Settlement costs resulting from its management decisions, Mr.

¹⁸ *Id.* at 23, 39, 42.

¹⁹ *Id.* at 27.

²⁰ *Id.* at 80-81.

²¹ *Id.* at 46. Mr. Petros advised the Commission that this lack of demand for payment is one of the defenses raised by NGrid in the FAF Action. He argued that “it would have been unreasonable for the company to maybe go out looking for a claim to be brought against it...” *Id.* at 47.

²² *Id.* at 60. Mr. Gerwatowski represented that the remaining WSOSA in the EUA territory with another supplier does not contain the same provision as the Constellation WSOSAs and as such, should not be subject to a claim for FAF payments. *Id.* at 70.

Gerwatowski maintained that the Company acted in a prudent manner in performing its WSOSAs and has managed the contract disputes through the use of management time and money. He stated that the Company believed it could prevail in both claims, but this Settlement “makes sense because it cuts off a potential liability that’s just not acceptable to sustain or even take a risk on....and that’s the reason why in this instance it’s just and reasonable for the Commission to approve this Settlement and approve the cost incurrence under the Settlement.”²³

Discussing the dispute regarding costs arising from the forward capacity market, Mr. Warshaw explained that capacity is the “iron in the ground” used to generate electricity. Under FERC’s rules, generators are paid a specific amount each month based on the capacity of the generating unit adjusted for actual performance.²⁴ The ISO marketplace determines the capacity requirements which are generally the responsibility of the load that’s being served by the generation. Load serving entities can meet capacity requirements by owning generation, contracting for specific output from a generator, purchasing capacity from the market, or paying the ISO clearing price.²⁵ Constellation’s argument is that under FERC’s most recent rules, the quantity of capacity required has increased and that the price of capacity has also increased.²⁶ There was a dispute over whether or not the change in regulations required NGrid and Constellation to enter into arbitration.²⁷ With regard to the remaining SOS contracts, it was represented that the

²³ *Id.* at 61-64.

²⁴ *Id.* at 40.

²⁵ *Id.* at 41.

²⁶ *Id.* at 42.

²⁷ *Id.* at 31-32. *See supra* notes 13-15 and accompanying text.

other suppliers all signed onto the FERC settlement and as such, will not be making similar claims under their respective SOS contracts.²⁸

Mr. Gerwatowski clarified that the Company is seeking approval of the Settlement and associated cost recovery, but not of the actual contract amendments.²⁹ He also acknowledged that the cost recovery methodology would be subject to Commission approval in a separate proceeding.³⁰ Ms. Lloyd clarified that her analysis of rate impact submitted in this proceeding did not account for any projected over-collection and would be subject to change when NGrid files for its Annual Reconciliation of SOS rates.³¹

IV. Commission Findings

On September 30, 2008, at an Open Meeting, the Commission considered the evidence presented and unanimously approved the Settlement, finding it to be in the best interest of ratepayers.³² It is never the Commission's first choice to approve a Settlement that will result in higher costs for ratepayers where there is a dispute over the liability for those costs. However, in this case, the potential liability to NGrid and its ratepayers for disputed FAF and capacity charges, together with the risk that is always associated with litigation, puts the Commission in the difficult position of approving a Settlement that would result in approximately \$50 million in certain increased costs, or take the risk of exposing ratepayers to \$300 million in increased costs long after the WSOSAs and PSAs in dispute have expired. If the Commission was to take the risk and deny the Settlement and Constellation prevailed, ratepayers would suffer increased costs quite unnecessarily and the \$50 million would seem to be a bargain. Of course, NGrid and the Division

²⁸ *Id.* at 71.

²⁹ *Id.* at 34.

³⁰ *Id.* at 34-35, 66.

³¹ *Id.* at 36.

³² The Commission notes that it has not approved the Amendments referenced by the Settlement as such approval was not before the Commission.

could prevail in their respective actions and rather than being seen as a bargain, the \$50 million would be seen as a gift to Constellation, so regardless of the decision made, the decision of the Commission will be questioned.

Therefore, in reaching its decision regarding what is in the best interest of ratepayers, the Commission evaluated the parties' positions regarding the level of litigation risk together with potential liability. The Commission reviewed responses to data requests and schedules prepared by the parties. Of particular note, assuming Constellation was to prevail only for the period April 2008 through December 2009, and assuming the Commission used the pre-2005 formula for calculating FAF payments to Constellation for the period April 2008 through December 31, 2009, ratepayers would be liable for an estimated \$94,590,842 in additional SOS payments.³³ This does not even take into account the dispute regarding forward capacity payments, estimated at \$100 million.

Furthermore, if the Commission was to choose to deny the Settlement and litigation was to proceed, decisions in the two matters would not be reached until after the WSOSAs and PSAs expire on December 31, 2009. In the event Constellation were to prevail, ratepayers would be subject to costs related to a prior period under these contracts at a time when they are receiving service under new contracts. Such a disconnect would add to customer confusion and claims of unfair rate treatment.

A review of the prudence of a utility's management decisions is the first step of any analysis regarding the appropriateness of cost recovery. In the case of cost recovery under NGrid's WSOSAs and PSAs, the Commission must also review the relevant law. R.I. Gen. Laws § 39-1-27.3 states, "The electric distribution company will be entitled to

³³ See NGrid Ex. 2.

recover its costs incurred from providing the standard offer arising out of (1) wholesale standard offer supply agreements with power suppliers in effect prior to January 1, 2002; (2) power supply arrangements that are approved by the commission after January 1, 2002;... and (4) any other power supply related arrangements prudently made after January 1, 2002 to provide standard offer supply....” The WSOSAs at issue were entered into prior to January 1, 2002. With regard to the FAF, in this case, the Company is entitled to recover those costs from ratepayers.

Of course, if NGrid acted illegally or incurred additional costs from imprudent actions, the Commission does not believe the legislature intended for NGrid to be rewarded. A clear example would be where the contract requires payment within a certain time from receipt of an invoice and NGrid just decides not to pay and incurs additional interest and penalties. The Commission believes it could deny recovery of such additional costs. However, that is not the case here. In this instance, NGrid interpreted its contract in good faith in a manner that saved ratepayers millions of dollars and acted accordingly. Had NGrid made payments to Constellation for the period January 1, 2005 through March 31, 2008 under provisions it did not believe required FAF payments, ratepayers would have paid in excess of \$90 million in additional rates for SOS.

NGrid acted prudently under the circumstances. It is clear from the record and from a review of prior related SOS reconciliation matters before the Commission that NGrid believed that the WSOSAs in the EUA zone did not require payment of a FAF. The Company, through its witnesses, testified on several occasions prior to 2005 that a FAF was not required under its interpretation of the contracts. No supplier challenged

such a claim in any Commission proceedings. Also, Mr. Gerwatowski reiterated that it was the Company's belief that in not billing for FAF payments after December 31, 2004, Constellation concurred with NGrid's interpretation of the contract. The old adage "don't go borrowing trouble" seems applicable in this case. While one supplier asserted its claim to continued FAF payments immediately and made NGrid aware that it disagreed with the Company's interpretation of the contract, it would not have made sense for NGrid to approach another supplier and ask if they would like to also receive payments where NGrid believed their interpretation of the contract was correct.

With regard to the forward capacity market dispute, NGrid and the Division on behalf of the State of Rhode Island believed they were entering into a Settlement before FERC that would protect ratepayers from additional costs related to SOS with all SOS suppliers in Rhode Island. The Division and NGrid still believe that Constellation is not entitled to additional payments under its WSOSAs and PSAs. However, in order to limit exposure to ratepayers and avoid additional litigation risk, the Commission agrees that this overall Settlement is in the best interest of ratepayers, in large part to bring about closure for ratepayers, especially when weighed against litigation risk and potential valuation.

Finally, the Commission reiterates that it has not yet determined the method of cost recovery. The method of cost recovery will be designed to limit the impact of the Settlement on ratepayers and will be addressed in NGrid's Annual Reconciliation filing which is to be filed no later than November 15, 2008. The method of cost recovery will include the term and a review of the interest calculation.

Accordingly, it is hereby

(19466) ORDERED

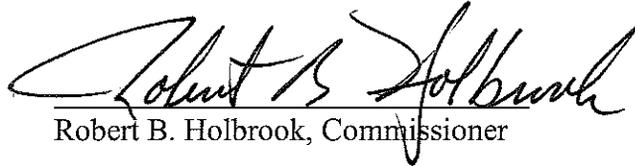
1. The Settlement Agreement between Narragansett Electric Co. d/b/a NGrid, Constellation and the Division of Public Utilities and Carriers filed on September 2, 2008 is hereby approved.

EFFECTIVE AT WARWICK, RHODE ISLAND PURSUANT TO AN OPEN MEETING DECISION ON SEPTEMBER 30, 2008. WRITTEN ORDER ISSUED OCTOBER 21, 2008.

PUBLIC UTILITIES COMMISSION



Elia Germani, Chairman



Robert B. Holbrook, Commissioner



Mary E. Bray, Commissioner

