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June 26, 2009

Ms. Luly Massaro, Clerk
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89 Jefferson Boulevard
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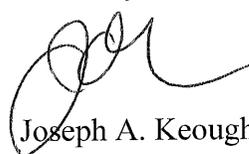
Re: Narragansett Bay Commission – Docket No. 4026

Dear Ms. Massaro:

Enclosed please find an original and nine (9) copies of the Narragansett Bay Commission's Memorandum in Support of Changes in Rates. Please file in your customary manner. An electronic copy of this filing has been provided to the service list.

Thank you for your attention to this matter.

Sincerely,



Joseph A. Keough, Jr.

JAK/kf
Enclosure

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

IN RE: NARRAGANSETT BAY COMMISSION

DOCKET NO: 4026

**MEMORANDUM IN SUPPORT OF NARRAGANSETT BAY COMMISSION'S
PROPOSED CHANGES IN RATES**

June 26, 2009

I. INTRODUCTION

On December 22, 2009, the Narragansett Bay Commission (“NBC”) filed an application to increase rates pursuant to Rhode Island General Laws § 39-3-11 and Part II of the Rhode Island Public Utilities Commission’s (“Commission”/“PUC”) Rules of Practice and Procedure. NBC’s proposed rates were designed to collect revenues in a twelve (12) month period equal to \$78,751,850. In support of its filing, NBC submitted testimony and supporting schedules from Walter E. Edge, Jr., MBA, CPA, President of B&E Consulting, LLC and Maureen Gurghigian, Managing Director with First Southwest Company. As required by law, the Division of Public Utilities and Carriers (“Division”) reviewed NBC’s rate application and submitted testimony and supporting schedules from Thomas Catlin and Lafayette K. Morgan, Jr. from Exeter Associates, Inc.

NBC’s application for increased rates was driven by five primary factors:

1. Decreased revenue and consumption;
2. A request to begin monthly billing;
3. Proposed increases in salaries and related benefits;
4. Utility increases; and,
5. Operational costs related to a full year of operation of the CSO Phase I Facilities.

At the June 9, 2009 hearing, NBC submitted an Exhibit outlining the parties’ positions throughout the litigation of this docket.¹ This Exhibit demonstrated that after the Division filed its surrebuttal testimony, four issues remained in dispute. These issues were salaries, health benefits, electricity costs and the net operating reserve. At the June 9, 2009 hearing, Mr. Edge testified that after reviewing Mr. Morgan’s surrebuttal testimony, NBC accepted the Division’s adjustments, and underlining methodology, to

¹ NBC Exhibit 3

salary expenses, health benefits and electricity costs. Thus, only one issue – net operating reserve – remained in dispute. This Memorandum will address this sole area of disagreement and two additional issues raised during the litigation of this Docket.

II. LEGAL STANDARD

Pursuant to R.I.G.L. § 39-3-2, when a public utility proposes a rate increase it has the burden of proving that the increase is necessary to obtain reasonable compensation for services rendered. NBC asserts that it has met this burden. Thus, NBC requests that its proposed rates be granted by the Commission.

III. ARGUMENT

1. NET OPERATING RESERVE

NBC's original filing requested a net operating reserve of \$561,878,² which equaled 1.5% of rate year expenditures (less debt service).³ As Mr. Edge testified, "the net operating reserve is designed to address unknown or unanticipated expenses during the rate year that may be related to price increases or increased usage."⁴ The Division recommends an operating reserve of \$170,000, which equals "1% of operating expenses, excluding personnel and debt service costs."⁵ Mr. Morgan testified that his net operating reserve calculation was "consistent with the Commission's Order in NBC's last rate case," and that he adhered to "the established framework" for deriving this expense."⁶

² NBC reduced its net operating reserve to \$549,406 in its rebuttal testimony.

³ W. Edge Rebuttal Testimony, p.19

⁴ W. Edge Rebuttal Testimony, p.19

⁵ L. Morgan Direct Testimony, p. 16

⁶ L. Morgan Rebuttal, p.10

Mr. Catlin provided similar testimony during the hearing. “In this case we’ve simply continued to accept the Commission’s decision in the last several dockets.”⁷ “Simply put, I think the Division recognizes that the issue of the appropriate operating reserve allowance is a matter of Commission discretion.”⁸ Thus, the Division does not seem to be diametrically opposed to NBC’s request. Rather, the Division has seemingly adopted a position of neutrally accepting past practices. NBC takes the position that conformity with prior decisions regarding this issue is detrimental to both NBC and its customers.

As set forth in pre-filed testimony, NBC’s credit rating was recently upgraded to AA-, which is a significant accomplishment, and one that NBC had been focusing on for several years.⁹ The AA- credit rating will allow NBC to issue revenue bonds at favorable rates and access the market without insurance.¹⁰ This is an incredibly important issue for NBC and its ratepayers. As Mr. Catlin pointed out in his testimony, “more than 50 percent of NBC’s costs are debt service related costs.”¹¹ Thus, NBC’s ability to reduce its borrowing costs directly impacts the rates paid by its customers.

As established in its pre-filed testimony, NBC has been negatively impacted by a severe decrease in consumption and an associated drop-off in collected revenue. Hopefully, many of these consumption and revenue issues will be remedied by the steps NBC has taken in this Docket. However, a proper net operating reserve also plays an important role in NBC’s efforts to improve its credit rating.

⁷ Hearing Transcript, p. 47-48

⁸ Hearing Transcript, p. 48

⁹ M. Gurchigian Direct, p. 3

¹⁰ W. Edge Direct, p. 3

¹¹ T. Catlin Direct, p. 8

To begin with, a proper net operating reserve would have a positive effect on NBC's debt coverage calculation, which is required to be performed by NBC's independent auditor as part of the annual financial statement audit.¹² To date, the annual calculation has shown adequate debt service coverage.¹³ However, the downward trend in coverage allowance shown in NBC's June 30, 2008 Financial Statements is alarming.¹⁴ As shown in the "Other Financial Information" section (page 65), the annual coverage allowance declined from its peak of 2.11 in FY 2003 to 1.27. In FY 2008, it barely met the required level of 1.25.¹⁵

The debt service coverage calculation begins with subtracting operating expenses (exclusive of depreciation and amortization) from gross revenues to arrive at net revenue available for debt service.¹⁶ The net revenue is then divided by the total principal plus interest to arrive at the coverage.¹⁷ Because actual revenues are in the numerator of the calculation, any reduction in revenues results in a reduction in the calculated coverage.¹⁸ However, increased expenses can also affect the calculation. If the rate year revenue is less than authorized, and expenses and debt service are not equally *less* than authorized, the revenue shortfall will have a significant negative impact on the overall coverage.¹⁹ Thus, increased expenses can also have an adverse impact on coverage.

Failure to meet coverage requirements is a cause for concern.²⁰ Debt service coverage is an indication of a system's ability to service its debt, which is a major

¹² W. Edge Direct, p. 23

¹³ W. Edge Direct, p. 23

¹⁴ W. Edge Direct, p. 23

¹⁵ W. Edge Direct, p. 23

¹⁶ W. Edge Direct, p. 24

¹⁷ W. Edge Direct, p. 24

¹⁸ W. Edge Direct, p. 24

¹⁹ W. Edge Direct, p. 24

²⁰ M. Gurghigian Direct, p. 6

consideration for bondholders and investors.²¹ Debt service coverage tends to correlate with liquidity.²² Generally, the higher the coverage ratio, the higher the credit rating.²³

In addition to coverage requirements, system liquidity is also a credit factor.²⁴ Credit rating agencies use the number of days of operating cash on hand as a measure of liquidity.²⁵ In NBC's case, this has been declining dramatically. Standard & Poor's most recent credit report noted that NBC's unrestricted cash and investments in FY 2007 were \$15.5 million or 190 days of operating expenses, which was down significantly from 500 days in FY 2004.²⁶ This deteriorated further in FY 2008 with unrestricted cash and investments of \$13.6 million (\$1.9 million lower than the prior year) or 158 days of operating expenses.²⁷ Certainly, increased and unexpected expenses which are not addressed by an adequate net operating reserve can adversely affect cash on hand.

Thankfully, NBC's revenue shortfalls have been offset by O&M spending at levels less than those approved by the Commission. Last year in particular, NBC benefitted from a "dry" year with cost savings in rainfall and inflow related costs which are out of NBC's control.²⁸ If this was not the case, NBC would have experienced major difficulties. In fact, if operation and maintenance costs were even *equal* to those approved by the Commission, NBC would not have met its coverage requirements in FY 2008.²⁹ Clearly, if expenses *exceeded* the levels set by the Commission, the situation would have been dire. Since NBC cannot always control unexpected expense increases, a properly

²¹ M. Gurghigian Direct, p. 6

²² M. Gurghigian Direct, p. 6

²³ M. Gurghigian Direct, p. 6

²⁴ W. Edge Direct, p. 22; M. Gurghigian Direct, p. 6-7

²⁵ W. Edge Direct, p. 22

²⁶ W. Edge Direct, p. 22

²⁷ W. Edge Direct, p. 22

²⁸ W. Edge Direct, p. 19

²⁹ W. Edge Direct, p. 18-19

funded net operating reserve is essential to NBC's credit rating. This is especially true in the rate year (FY 10) for a number of reasons.

First, monthly billing will not begin until October 2009. Thus, NBC will not be issuing monthly bills for the entire fiscal year. As a result, some of NBC's revenue issues may linger through the year.

Second, the CSO Phase I Facilities will be operating for the entire rate year ending June 30, 2010.³⁰ There are increased utility costs for operating the new tunnel pump station and increased costs for treating additional flow from the CSO tunnel to the Field's Point Wastewater Treatment Facility.³¹ As this is the first year of full operation, the associated expense could easily be higher than anticipated.

Third, NBC has large expenses related to treatment for items such as biosolids, electricity, gas and chemicals. These expenses are required to meet permit regulations and are impacted by factors such as rainfall, which is outside of NBC's control. In this Docket, the agreed upon expense for electricity is \$3,805,528 and biosolid disposal is \$4,567,257. The net operating reserve recommended by the Division is \$170,000. Thus, NBC would not be able to cover a mere two and half percent increase (\$209,319.62) in just these two items.

The Commission has recognized the need to deviate from past practice in setting operating reserves for water utilities in the State of Rhode Island. (See Kent County Docket 3942 and Providence Water Docket 3832). NBC believes that the time has come for the Commission to recognize the need to deviate from past practice in setting an appropriate increased net operating reserve for NBC as well.

³⁰ W. Edge Direct, p.5

³¹ W. Edge Direct, p.5

2. SUSPENSION OF RATES

During the hearing, Chairman Germani asked the parties to address a specific legal issue. In particular, what would happen if the two sitting Commissioners did not agree on NBC's request for an increased net operating reserve. The answer to that question – like many legal questions – is that it depends on the nature of the Commission's Order. Pursuant to R.I.G.L. §39-3-11, when the Commission receives notice of a proposed rate increase, it may hold a public hearing and make investigation into the propriety of the proposed increase.³² The Commission then has the power to suspend the proposed increase, but not for a period longer than six months.³³ Within ninety days after the completion of any hearing, the Commission must render an Order regarding the proposed rate increase.³⁴

In *Bristol County Water Co. v. Public Utilities Commission*, 363 A.2d 444 (RI 1976), the Rhode Island Supreme Court stated that R.I.G.L. §39-3-11 is a “mandatory statute, requiring the Commission to come forth with a decision and order within ninety (90) days of the completion of a rate hearing.” Certainly, a case can be made that if there is a tie vote on NBC's request for an increased net operating reserve, then no Order has been issued on this request. This would constitute a violation of R.I.G.L. §39-3-11.

The Supreme Court has stated that when the Commission fails to issue a timely Order pursuant to R.I.G.L. §39-3-11, it forfeits its power to further suspend a utility's filing until it comes forward with the statutorily required Order. *Bristol County Water Co. v. Public Utilities Commission*, 363 A.2d 444 (RI 1976). As such, the proposed increased

³² R.I.G.L. §39-3-11

³³ R.I.G.L. §39-3-11

³⁴ R.I.G.L. §39-3-11

net operating reserve could be put into effect until there is an agreed-upon decision by the Commission.

3. MONTHLY BILLING AND RATE DESIGN

A. MONTHLY BILLING

One of the most important elements of NBC's rate application is its request to move from quarterly billing to monthly billing. As set forth in Mr. Catlin's direct testimony, the Division supports NBC's request to bill monthly. Nevertheless, and because of the importance of this issue, NBC takes this final opportunity to review the parties' positions and the basis for their agreement on this matter.

In moving to monthly billing, NBC seeks to bill one-twelfth of its service charge in advance each month instead of billing its customers one-quarter of the annual service charge in advance each quarter.³⁵ In addition, NBC has redesigned its billing software, which allows it to bill for estimated usage on a monthly basis.³⁶ This estimated billing can then be "trued up" when actual usage data is received.³⁷

It is NBC's position that monthly billing will benefit both the utility and its customers. Monthly billing will help make bills more affordable to ratepayers, who will be able to budget for smaller monthly bills. At the same time, monthly billing will help alleviate some of NBC's revenue lag issues and will smooth out cash-flow. The advantages, and importance, of this new billing schedule were identified by several witnesses in this Docket:

³⁵ W. Edge Direct, p. 26

³⁶ W. Edge Direct, p. 26

³⁷ W. Edge Direct, p. 26

W. Edge Testimony

- “From a cash standpoint, monthly billing will allow NBC to bill the consumption revenue in the same fiscal year that it is recognized as revenue on a GAAP basis. The reduction of the billing lag will strengthen NBC’s cash position, the system’s liquidity, and offset revenue lags resulting from delays in the actual billing of consumption.”³⁸
- “Monthly billing will result in the billing and collection of consumption billed at current rates as opposed to collecting receivables billed at old rates.”³⁹
- “From a cash management standpoint, the current cash flow peaks will be smoothed, resulting in a constant cash flow that will help NBC make the required monthly deposits.”⁴⁰
- Improvements to cash flow resulting from monthly billing “will enhance NBC’s liquidity and may help NBC maintain or improve its AA- credit rating.”⁴¹

T. Catlin Testimony

- NBC has not requested recovery of the conversion costs associated with the change to monthly billing such as re-designing its billing software.⁴²
- In addition, the ongoing costs are not significant. The \$387,242 of incremental expense requested by NBC represents an incremental cost per bill of approximately \$0.25.⁴³

³⁸ W. Edge Direct, p. 26

³⁹ W. Edge Direct, p. 26

⁴⁰ W. Edge Direct, p. 26

⁴¹ W. Edge Rebuttal, p. 2

⁴² T. Catlin Direct, p. 5

⁴³ T. Catlin Direct, p. 5

- The change to monthly billing will not have an adverse effect on small customers because NBC has effectively proposed to divide the quarterly service charge by three to determine the monthly service charge. NBC has not proposed to assess the same customer charges for monthly billing that it now assesses on a quarterly basis.⁴⁴
- “The conversion to monthly billing will result in a significant reduction in the amount of NBC’s unbilled receivables. This will occur because, instead of billing for consumption or usage by at least three months, and as much as 12 or more months, in arrears, consumption will be billed only one month in arrears.”⁴⁵
- The improvement in cash flow will help NBC maintain or improve its recently achieved AA- Standard & Poore’s Credit Rating and help minimize NBC’s costs of borrowing.⁴⁶
- Customers who are currently billed annually (or semi-annually) for their consumption will no longer experience one large bill each year (or every six months) for their usage charges. The average consumption charges for residential customer are \$204 per year at current rates and estimated 2009 consumption. Having those charges spread out over the course of a year will make it easier for those customers to budget and pay their bills.⁴⁷

M. Gurghigian Testimony

- “Credit rating agencies consider several factors when establishing agencies marketability. One of those factors is financial flexibility or liquidity. NBC’s operational risk or revenue and expense volatility is increasing as a result of its current revenue shortfalls. For NBC, the conversion to monthly billing would equate to increasing the ability to meet its debt service liability. Improving

⁴⁴ T. Catlin Direct, p. 5

⁴⁵ T. Catlin Direct, p. 6

⁴⁶ T. Catlin Direct, p. 6

⁴⁷ T. Catlin Direct, p. 6

NBC's cash flow will help to enhance its liquidity and help NBC to maintain its recently upgraded credit rating."⁴⁸

B. RATE DESIGN

As noted in Mr. Catlin's direct testimony, NBC originally proposed to recover its requested revenue increase through a uniform percentage increase in service charges and consumption charges.⁴⁹ However, Mr. Catlin suggested that the increase allowed by the Commission be recovered through increased dwelling unit and meter service charges.⁵⁰ Mr. Catlin proposed to allocate the allowed increase between residential and non-residential customers in proportion to test year revenues at present rates.⁵¹ He then proposed to recover the revenue increase allocated to the residential class through a uniform increase in the per dwelling unit charge.⁵² To recover the portion of revenue allocated to non-residential customers, he recommended that the current service charges based on meter size be increased by a uniform percentage.⁵³ Mr. Catlin cited several reasons in support of his recommendations:

- Recovery on this basis is consistent with the fact that the major factor affecting NBC's revenue requirement is the cost of the CSO project and the treatment of storm water, which is not a function of customers' waste water volumes.⁵⁴
- In addition, more than 50% of NBC's costs are debt services related costs. As customers reduce consumption, recovery of additional revenue through service

⁴⁸ M.Gurghigian Rebuttal, p. 3

⁴⁹ T. Catlin Direct, p. 6

⁵⁰ T. Catlin Direct, p. 7

⁵¹ T. Catlin direct, p. 7

⁵² T. Catlin Direct, p. 7

⁵³ T. Catlin Direct, p. 7

⁵⁴ T. Catlin Direct, p. 8

charges will provide a more stable revenue stream to meet this high level of debt service.⁵⁵

- Recovery of additional revenues through fixed service charges will address concerns raised by the rating agencies with regard to NBC's revenues, which will help maintain or improve its credit rating. This will, in turn, assist in minimizing revenue requirements by reducing borrowing costs.⁵⁶

As set forth in Mr. Edge's rebuttal and hearing testimonies, NBC fully supports Mr. Catlin's change in rate design related to monthly billing. In fact, both Mr. Edge and Ms. Gurghigan pointed out added advantages to Mr. Catlin's rate design:

- Shifting a greater portion of revenue recovery to fixed fees would be viewed more favorably by rating agencies as it would increase revenue stability.⁵⁷
- NBC's improved credit rating should result in lower borrowing costs which helps mitigate the impact of debt service payments on rate payers.⁵⁸

For these reasons, NBC asks that the Commission approve the move to monthly billing and the rate design agreed to by NBC and the Division.

⁵⁵ T. Catlin Direct, p. 8

⁵⁶ T. Catlin Direct, p. 8

⁵⁷ W. Edge Rebuttal, p. 5 and M. Gurghigan Rebuttal, p. 3

⁵⁸ W. Edge Rebuttal, p. 5 and M. Gurghigan Rebuttal, p. 4

III. CONCLUSION

For the reasons set forth herein, the Narragansett Bay Commission requests that the Rhode Island Public Utilities Commission grant the relief sought by NBC in its rate application (and subsequent revisions thereto) and that the Commission grant all other relief it deems meet and just.

THE NARRAGANSETT
BAY COMMISSION

By its attorney,

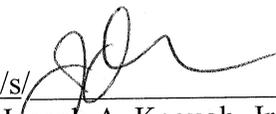


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CERTIFICATION

I hereby certify that I sent by electronic mail a copy of the within to all parties set forth on the attached Service List on June 26, 2009, and one original to Luly Massaro, Clerk, Rhode Island Public Utilities Commission.

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