STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
BEFORE THE PUBLIC UTILITIES COMMISSION

IN RE:	**THE NARRAGANSETT ELECTRIC**	**:**	
	COMPANY – INVESTIGATION	**:**	**DOCKET NO. 4065**
	AS TO THE PROPRIETY OF	**:**	
	PROPOSED TARIFF CHANGES	**:**	

POST-HEARING REPLY BRIEF OF THE DIVISION OF PUBLIC UTILITIES AND CARRIERS

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I. INTRODUCTION

On January 22, 2010, the Division and the Company filed their respective Post-Hearing Briefs with the Commission. For the most part, in its Brief, the Company did not shed further light on the merits of the pending matter, other than to reiterate positions previously advanced by the Company at hearing. This Reply, therefore, is limited to responding to a few select areas of the Company's Brief. The omission of a response to a particular position of the Company in its Brief should not be deemed as a waiver of the position advocated by the Division in its direct and surrebuttal testimonies and Post-Hearing Brief, all of which remain legally and factually unrebutted.

II. DISCUSSION

A. RATE OF RETURN

1. Cost of Debt/Capital Structure

The Company includes a 6.79 percent cost of debt placeholder, which its witness acknowledges is out of line with current market costs. 11/12/2009 Tr. at 58. The Division has provided a more current and realistic estimate of 5.6 percent, which has not been contested. Kahal Surrebuttal at 3. The Division has authorized the Company's issuance of $550 million of new long-term debt with the expectation that the issuance(s) will be completed in the first quarter of 2010. In Re: The Narragansett Electric Company d/b/a National Grid, Application for Authority to Issue Long-Term Debt, Docket No. D-09-49, Order No. 19847 (December 9, 2009). The very low interest rate environment has continued to hold since the November 2009 hearings, and the Division, therefore, has every expectation that this issuance will produce an embedded cost of debt reasonably close to 5.6 percent. The Division, however, does not necessarily oppose using the actual cost of debt at a later date after the issuance has been completed and final costs are known, as suggested by the Company. However, the Division reserves its right to review the debt issuance results and the Company's debt rate cost calculations at that time before accepting the results for setting rates. This caution is warranted given the enormous and unprecedented (for the Company) size of the issue, as much as $550 million. Until this is accomplished, the Division urges the Commission to use a 5.6 percent cost of debt as a placeholder value in this case for the calculation of the Company's revenue deficiency.

In addition, the Record supports a short-term debt cost rate no higher than 1.6 percent. Company Response to Division Data Request No. 31-13. On page 9 of its Brief, the Company proposes 2.5 percent, but this is contradicted by Mr. Moul who now supports Mr. Kahal's 1.6 percent. 11/12/2009 Tr. at 9.

At page 10 of its Brief, the Company suggests that the authorization to issue $550 million of new long-term debt will somehow determine its actual capital structure, and that its "actual capital structure will be known and measurable at the time rates are set …." This is not true. There are many variables that determine a company's capital structure above and beyond long-term debt issuances (*e.g.*, short-term debt balances, dividend payments to the parent, *etc.*). Moreover, the Company's assertion misses the point. The Company already has acknowledged that its current actual capital structure is inappropriate for ratemaking, Moul Rebuttal at 5, and no one knows what its actual capital structure will be three months, six months or a year from now. The issue is what is an economical and appropriate capital structure for setting rates in this case.

The Company insists that the Commission must simply rubber stamp whatever capital structure it asserts will result from its "recapitalization plan." To the contrary, sound ratemaking requires inclusion in rates of only those costs that are prudently incurred, including the costs of capital. Narragansett Electric Co. v. Harsch, 368 A2d 1194, 1211 (R.I. 1977). Indeed, the Company acknowledged this at Paragraph 15 of the Settlement Agreement reached in Division Docket No. D-09-49:

> 15. The Company retains an obligation to use a prudent mix of capital to finance its utility operations and investments.

In that regard, the Division maintains that based on industry experience a 47.5 percent common equity ratio would be preferable and more economic than the unsupported 50.05 percent proposed by the Company. Moreover, as Mr. Kahal has shown, the Division's 47.5 percent common equity ratio is conservatively high relative to the experience of other Company utility affiliates in other states. Kahal Direct at 9; Kahal Surrebuttal at 5. Rhode Island customers should not be burdened with an overly expensive capital structure.[1]

2. Cost of Equity

In connection with the subject of cost of equity, the Company focuses primarily on one narrow issue—the appropriate dividend growth rate that should be used in Mr. Kahal's Discounted Cash Flow ("DCF") studies (*i.e.*, the electric distribution proxy group study). Mr. Kahal reported a DCF range of 9.7 to 10.2 percent for his gas proxy group, a result that the Company did not contest. Kahal Direct at 37. The Company contends that had Mr. Kahal used the same growth rate method for his electric group that he used for the gas group, he would have obtained 10.6 to 11.1 percent, which when averaged with the gas DCF study result would produce a cost of equity of 10.4 percent, not 10.1 percent. Company Brief at 15. The Company attempts to provide further support for its position, moving the Division's position to 10.4 from 10.1 percent, by stating that the average electric utility return on equity ("ROE") award in 2009 was 10.43 percent. Id. at 16.

The Company's proposed "correction" of the Division's electric proxy, DCF study is based on the notion that the only valid measure of expected long-term dividend growth is a survey of

[1] The Company's citation to Docket No. 2290A & B, Order No. 14857 and Docket No. 3617, Order No. 18037 on Page 10-11 of its Brief is wholly inappropriate. In both Orders, the Commission (in approving the stipulation) and the Company (in executing the settlement) expressly affirmed that the settlements in those dockets established, "no principles," Order No. 18037 & 14855, and were not to be deemed "to constitute a determination by the Commission as to the merits of any issue" in any rate proceeding. Order No. 14857.

published five-year earnings growth rates prepared by securities analysts. This seems to be the position of Company witness Moul. In fact, Mr. Kahal employed this growth measure in both his gas and electric DCF studies, *but not exclusively*. At pages 34-35 of his direct testimony he warns that reliance on projected earnings "warrants substantial though not necessarily exclusive emphasis" and proceeds to discuss this measure's limitations. He notes that published earnings projections "may overstate the long-term, sustained growth rate that the DCF model requires." Kahal Direct at 35. For that reason, he also considers projected Book Value growth and Retained Earnings growth (as forecast by Value Line). For the gas group, the difference is relatively small (*i.e.*, a retained earnings growth rate of 4.83 percent which approximates the 5.0 percent lower bound growth rate). Id., Schedule MIK-4, page 4 of 4. For the electric group, Book Value growth is 3.8 percent and Retained Earnings growth is 3.5 percent. Id., Schedule MIK-5, page 4 of 4. In conjunction with the 4.87 percent earnings growth rate, id., Schedule MIK-5, page 3 of 4, this fully supports the electric proxy group DCF range of 3.8 to 4.8 percent selected by Mr. Kahal.

In summary, the inconsistency alleged by the Company is imagined and not real. The assertion is based upon the faulty assumption that the only evidence on DCF growth that can be used is projected five years earnings growth. In fact, Mr. Kahal used that measure but supplemented by Book Value and Retained Earnings growth projections to develop a reasonable range. The record evidence demonstrates that a reasonable cost of equity for Narragansett at this time is no higher than the 10.1 percent, not the 10.4 percent claimed by the Company in its Brief.

Finally, it may be true that the year-to-date 2009 average ROE award is 10.43 percent. However, that figure is for the industry as a whole and fails to account for: (1) the pronounced downward trend in capital costs in 2009 as financial markets recover; and (2) the fact that Narragansett is a very low risk, "wires" company. Vertically integrated electrics are considered riskier, and therefore, are likely to receive higher ROE awards.

B. REVENUE REQUIREMENTS

1. Plant Additions

The Company agrees that capital spending is running below forecasted levels, just not by as much as the Division claims, stating that "[a]s in Docket 3943 in 2008, the Division's recommended disallowance is based solely on a linear spending trend, which is likely to underestimate the Company's spending through the end of the rate year given the circumstances explained by Company Witness Pettigrew." Company Brief at 19. In fact, the method used by the Division in Docket 3943 resulted in an estimate of plant additions through the rate year that proved to be quite accurate, as evidenced by the Company's Capital Expenditures Tracker adjustment in Docket No. 4077.

The Company now proposes that the Commission adopt the mechanism from Docket No. 3943 here. No such mechanism is necessary in the present case. The Company's forecasts of plant additions have been shown to be excessive, based on the actual experience through September 2009. No credible evidence has been offered that the shortfall is being made up or will be made up by the end of the rate year. The Commission should adjust the rate year plant in service in the Company's rate base, to avoid customers paying for plant costs that do not exist.

2. Contracted Hiring Requirement

In its Brief on Page 21, the Company appears to imply that because the relevant contract section requires the elimination of "platform contractors" those are the only contractors that can possibly be displaced by the increased number of union employees. Any fair reading of the contract clearly shows that, while the elimination of platform contractors is mandated, the intent of the increase in union employees is to reduce the reliance on all outside contractors. How these other contractors are categorized and the expense of those other contractors in relation to platform contractors, see Company Brief, at 22, is of no relevance. Mr. Dowd explicitly testified that the contracted hiring requirement is "a commitment to increase the number of employees on our payroll with the awareness that some of that work exchange may be in lieu of contractor crews" and that the intent is to revert to "a model where there were more employees and fewer contractors." 11/5/2009 Tr. at 92-93. No evidence exists that the increase in union employees and concomitant reduction in outside employees will result in any net increase to expenses.

3. Incentive Compensation

The Company summarizes its position by asserting that, "validity of the Division's claim is undermined by the implication that, if the Company just restructured the plan to specifically refer to 'cost reduction' instead of 'the achievement of earnings,' which are inextricably related concepts, the Division would not object to its inclusion in rates." Company Brief at 25. There is, however, a major difference between "cost reduction" and "the achievement of earnings." Higher rates will result in higher earnings. Incentivizing employees to achieve lower costs may be in the best interest of customers. Incentivizing employees to achieve higher rates is not.

By law, the burden of proof lies with the Company—not with the Division—to show how the expense is necessary and reasonable to the provision of electric distribution service. G.L. § 39-3-12. E.g., Interstate Navigation Co. v. Burke, 465 A.2d 750, 758 (R.I. 1983). The Company's argument reflects an explicit concession of its failure to meet this burden. Providence Gas Co. v. Malachowski, 656 A.2d 949, 952 (R.I. 1995) (SERP Plan expenses that benefited company executives but did not directly benefit ratepayers were properly disallowed).

4. Normalized Storm Expense

On Page 29 of its Brief, the Company states that the recorded storm damage "fluctuates from year to year and that it was higher in 2008 than it has been in other recent years." 11/5/2009 Tr. at 223. In other words, the test year storm damage must be normalized because the expense fluctuates and because the expense was abnormally high in the test year. The Company argues that the actual storm damage in 2004 should be eliminated from the five-year, average because the storm damage expense was lower in that year than in the other years and that there is "no basis to assert that the expense reported in 2004 is accurate, reasonable or appropriate." In fact, the storm damage of $437,000 is what the Company actually reported in 2004, and there is no evidence that this amount was in any way inaccurate. Obviously, if the lowest amount in the five-year average is eliminated, then the average expense of the remaining four years is going to be higher. However, such an arbitrary modification would not be appropriate. If the lowest year in the five-year period is eliminated, then the highest year should also be eliminated. The resulting three-year average would be $3,410,000, which is in the range of the five-year average calculated by the Division.

5. Injury and Damages Accrual

The Company claims that the event for which the special accrual was recorded in the 2008 test year has the potential to recur. In fact, the response to RR-COMM-19 (cited by the Company) identifies steps that have been taken to prevent such a recurrence. When given an opportunity to provide examples of such incidents that occurred in the past or that might possibly may occur in the future, Company witness O'Brien was unable to do so. 11/5/2009 Tr. at 10-11. The Company's statement that the total expense level for Injury & Damage expense in the 2008 test year was on par with prior years is simply false. The injuries and damages expense in the 2008 test year was $7,085,000. In the prior four years, the injuries and damages expenses were: 2004 – $3,881,000, 2005 - $2,244,000, 2006 - $6,360,000, and 2007 - $3,888,000. Effron Surrebuttal at 8. The average for this four-year period was $3,275,000. The $2,500,000 accrual in 2008 clearly caused the expense in that year to be abnormally high.

6. Credit Collections Expense

The Company misstates the Division's position. The Division does not argue that the incremental credit collections expense should be eliminated because there will be system benefits. The Division argues that the expense should be eliminated because the incremental efforts will result in reductions to uncollectible accounts expense, which should at least match the incremental cost of the program. Effron Direct at 10. Incremental costs that do not "pay for themselves" through decreased write-offs are not "reasonable" and "necessary" to achieve compensation for services rendered, and therefore, are not permitted under Rhode Island law. E.g., New England Tel. & Tel. Co. v. Public Utilities Comm'n, 446 A.2d 1376, 1383 (R.I. 1982).

7. Distribution-related Uncollectible Accounts Expense[2]

The Company principally contends that the recommended reduction in the charge off rate is not supported by any consideration of "customer-specific circumstances," Company Brief at 50-51, and cite two examples which allegedly support its position: (i) the alleged inclusion of "all amounts less than 60 days" to calculate an average account balance for residential and non-residential customers, and (ii) the allegation that 258 voluntarily terminated non-residential "may not have" had any arrearage balance. Id. at 52-53.

The Company's first point confuses the proper methodology for calculating the average balance and determining the number of customers available for disconnection, with the threshold

[2] Other than the reconciliation of uncollectible accounts expense, the Company has not pursued the other aspects of the distribution adjustment provision in its Brief. It must be reemphasized that reconciliation of distribution related uncollectible accounts expense is an inappropriate ratemaking methodology. Reconciling mechanisms are appropriate only for exceptional expenses that are large, volatile, and beyond the utility company's control. Effron Direct at 14. In advocating for the adoption of the proposed distribution adjustment provision, the Company has failed to show specifically how each of these criteria is satisfied. The Company's proposal, moreover, does not distinguish between increased write-offs related to increased sales and increased write-offs related to a higher percentage of billed revenues being uncollectible. Lastly, the proposed mechanism is one-sided. That is, it permits the Company to recover increases in uncollectible accounts expense but does not require any symmetrical credit to customers for decreases in uncollectible accounts expense. Effron Direct at 14-16.

cutoff—customers with balances at least 60 days past due ("DPD") (8,083)—which was selected for purposes of the analysis. The 8,083 accounts presented by Division Witness Gay include all the preceding past due buckets (331-360, 301-330...greater than 30 DPD). By conducting the accounts receivable analysis in this manner, Mr. Gay avoids double counting accounts and past due balances, and accurately depicts the total number of accounts and balances, which would be theoretically available for disconnection.

Based on actual performance in April 2008, the Company made no attempt to contact these 8,083 past due customers other than mailing disconnect notices to about 22% of them. During the same month, the Company disconnected less than 1% of these accounts with an average disconnection balance of $997. Clearly, the Company missed an opportunity to manage these past due accounts, particularly the aged accounts with very high balances (*e.g.,* 265 accounts greater than 360 DPD with average balances over $10,000). The accounts eligible for disconnection and the corresponding Company performance in the preceding months and years were similar.[3]

The Company's second contention relies on the erroneous implication that most or all of 258 accounts did not have an arrearage balance. Id. at 52. Mr. Gay explicitly testified that these were "high-balance" accounts, Gay Direct at 12, with an average balance per account of $8,175 and greater than 9 months past due. The Record reflects that the Company's implication is simply erroneous.

[3] The Company's argument with respect to residential customers contains the same fallacy. The overall example of the 51,395 accounts includes all the preceding past due buckets (331-360, 301-330...greater than 30 DPD). Again, by conducting the analysis in this manner, Mr. Gay avoids double counting accounts and past due balances, and accurately depicts the total number of accounts and balances, which would be theoretically available for disconnection.

Based on its actual performance in April 2008, the Company, again, made no attempts to contact any of these 51,395 customers by phone. The Company did mail disconnect notices to about 41% of them, but ultimately disconnected less than 2% of these accounts with an average disconnection balance of $587. Clearly, the Company missed an opportunity to manage these past due accounts, particularly the aged accounts with very high balances (*e.g.*, 3,026 accounts greater than 360 DPD with average balances nearly $1,400). The accounts eligible for disconnection and corresponding Company performance in preceding months and years were similar. The Company's inaction allowed the number of accounts and past due balances to increase over time.

In the final analysis, had the Company effectively managed its accounts receivable portfolios (*i.e.*, aged, past due accounts) in the years before 2008, it would not have experienced year-over-year increases in charge-offs. The Company should have reached out to these high-risk customers much earlier (*i.e.*, months or years earlier) when their balances were at manageable levels. Then the Company could have placed many accounts into different types of programs based on the individual circumstances of each account (*i.e.*, payment plans, low income programs, assistance programs, *etc.*).

8. Transmission-related Uncollectible Accounts Expense

On Page 56 of its Brief, the Company distorts the Division's position by implying that Mr. Effron agrees that recovery of transmission related uncollectible accounts expense should be addressed "through recovery of retail transmission rates in this case." The Division has clearly expressed its position that recovery of "expenses that are not properly part of the distribution cost of service, such as transmission related uncollectible accounts, should be eliminated from pro forma rate year expenses," and *"addressed when . . . transmission rates are set."* Effron Surrebuttal at 4 (emphasis added). The Company agrees with the Division that the transmission related uncollectible accounts expense should be removed from the distribution revenue requirement, Company Brief at 55, but improperly fails to make this adjustment in its supporting revenue requirement schedules.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that a copy of the within Reply Brief was e-mailed to the Service List in Docket No. 4065 on the 29th day of January, 2010.

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