Thomas R. Teehan
Senior Counsel

January 29, 2010

VIA HAND DELIVERY & ELECTRONIC MAIL

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

RE: Docket 4065 – National Grid's Request for Change of Electric Distribution Rates
Reply Brief

Dear Ms. Massaro:

Enclosed please find ten (10) copies of National Grid's[1] Reply Brief in the above-referenced proceeding.

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 4065 Service List

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

RHODE ISLAND PUBLIC UTILITIES COMMISSION

The Narragansett Electric Company d/b/a National Grid	))))	R.I.P.U.C. 4065

REPLY BRIEF
of
The Narragansett Electric Company
d/b/a National Grid

Submitted by:

Thomas R. Teehan
Cheryl M. Kimball, Esq.

Dated: January 29, 2010

I. Revenue Requirement Issues

A. Union Contract Labor Expense

In its Initial Brief, the Division asserts that the Commission should eliminate the Company's proposed adjustment of $1.363 million associated with its union labor contracts (Division Brief at 19). However, the Division has not provided the Commission with a valid basis for this disallowance.

The Division first cites two previous orders of the Commission allegedly standing for the proposition that the utility is required to provide "extensive detail" regarding the expense associated with the "hiring of additional employees" (Division Brief at 17). However, there was no issue involving the cost of "hiring additional employees" in Providence Gas Company, Docket No. 2286, Order No. 14859. This case discussed the ability of a utility to recover personnel expenses related to advertising expense under R.I.G.L. Section 39-2-1.2. Nor was the issue of "extensive detail" regarding the hiring additional employees discussed in In Re: Narragansett Bay Comm'n Abbreviated Application for Rate Relief, Docket No. 3592, Order No.18124, wherein the Commission made an adjustment to the reported staffing level due to fluctuation in the staff level over the course of a year. Most importantly, neither case involved an expense incurred as a result of a contractual obligation contained in a collective bargaining agreement, which specifically prescribes the number of people to be hired and the pay rate.[1]

Second, the Division disputes the testimony of Company Witnesses Dowd and Pettigrew regarding the reduction of *platform* contractors by pointing to two specific quotes contained in Sections 4 and 5 of an excerpt of the union contract provided in response to Division Data

[1] In terms of the Company's ability to enter into an obligation to hire union labor, the Rhode Island Supreme Court has found that the Commission cannot "interfere with a preexisting contract" and that any such interference is "prohibited" by "basic contract law." U.S.A. v. P.U.C., 635 A.2d 1135, at 1143-44 (R.I. 1993).

Request 1-2, which together state that (1) the Company and the Union will work jointly to identify an appropriate percentage of work to be performed by contractors, and (2) the Company has reserved its rights relative to the assignment of work and the allocation of the work plan between employees and contractors (see, DIV 1-20, at 3). In citing to these passages, the Division skips right over the quote at the beginning of Section 4 that states: "No later than May 11, 2010, the *Company shall cease the use of* ***platform*** *contractors*, which are those system crews staged on or off Company property who are assigned work that is day to day customer oriented" (see, DIV 1-20, at 3, Section 4)(emphasis added).

However, since the Division's claim is that cost incurred to hire additional union workers will be offset by reductions in the use of contractor labor, it is the language regarding the cessation of the use of platform contractors that is directly relevant to the Division's claim. There is no mention that the Company will "cease" or reduce the use of any other types of contractors, and without evidence that the use of other contractors will be reduced or that there will, in fact, be a reduction in total contract labor cost, the Division is wholly without record support for its claims. The passages referenced by the Division state only that the Company will work jointly with the union regarding contract labor, while *reserving all rights* to the Company to make choices regarding the assignment and allocation of contractor work. The Company has testified that it intends to *increase* the overall use of contract labor to meet its work plan. Consequently, there is not one piece of record evidence that shows that the increased union labor cost (committed to by contract) will be offset in whole or in part by reductions in contractor expense. The Division is not arguing that the union labor cost is imprudent, unreasonable or improper for inclusion in rates, but only that the union labor cost will be offset by reductions in

the cost of contractors, which is not proven with record evidence. Consequently, there is no basis for rejecting the Company's contract labor cost of $1.363 million.[2]

B. Variable Pay

The Division and the Attorney General argue that the Commission should accept the Division's adjustment to reduce incentive compensation. In support of this recommendation, the Division relies in part on Providence Gas v. Malachowski, 656 A.2d 949, 952 (R.I. 1995). In Providence Gas v. Malachowski, the Commission rejected certain costs associated with the Company's Supplemental Executive Retirement Plan ("SERP") based on a finding that SERP was an "attempt to reward executive talent for employment not dedicated to the company's ratepayers." Id. at 952. However, in that case, the utility's SERP program provided two executives with pension credit for years that *they had not served at the utility*, which are circumstances that are completely inapplicable to the payment of variable pay by National Grid. Id. at 951-952. This is not the circumstances at issue in this case. In this case, the record is clear that: (1) the incentive compensation proposed by the Company does not reward employees for work they performed at another company, and (2) the Company has excluded variable pay compensation for "Band A" executives in any event.

The record further shows that incentive compensation is the variable pay component of total employee compensation, which is paid to employees for work currently performed in the course of providing service to Narragansett customers. This type of compensation is an established standard in many jurisdictions, despite the Division's suggestion regarding the

[2] The Division cites to the decision of the Massachusetts Department of Public Utilities ("MDPU") denying the recover of post-test year adjustments to union labor costs in rates. However, as referenced by the Division in its brief, the MDPU's order stated that "*the evidence demonstrates* that the additional workers will displace outside contractors, and, therefore, there will be an offset cost savings not accounted [for] by National Grid" (Division Brief at 19, emphasis added). The evidentiary record is completely different in this case from the case before the MDPU.

impropriety of this type of cost under Utah public-utility law. For example, while relying on MDPU precedent for cost disallowances, the Division fails to mention that the MDPU approved recovery of 100 percent of National Grid's incentive compensation based on a finding that the plan provides benefits to customers.[3] Massachusetts Electric, D.P.U. 09-39 at 140-142 (2009).

More important, the Division fails to mention that this Commission has recently allowed incentive compensation to be included in rates in its decision in Docket No. 3943. See Docket No. 3943, Exhibit Laflamme Pre-filed Testimony, at 16-17 and Attachment NG-MDL at 7. The incentive compensation plan approved in Docket No. 3943 is identical to the plan giving rise to the rate year variable pay at question in this case. Consequently, a decision to disallow variable pay costs in this case would be completely arbitrary and contrary to Commission precedent.

II. REVENUE DECOUPLING

Both the Division and TEC-RI raise concerns about the Company's proposed Revenue Decoupling Ratemaking ("RDR") Plan, including the revenue-decoupling mechanism ("RDM"). Their concerns related to the question of whether the RDM is needed to achieve Rhode Island's ambitious energy efficiency goals; whether the RDM and RDR Plan will benefit consumers, and whether the Company really needs certain elements of the RDR Plan to fulfill its obligations to customers. Although certainly well intended, these concerns are misplaced.

A. Contrary to Assertions by TEC-RI and the Division, Revenue Decoupling is a Key Policy Tool for Achieving Rhode Island's Energy Efficiency Goals

Both the Division and TEC-RI argue that (in the words of TEC-RI), "the Company's Revenue Decoupling Ratemaking (RDR) plan is [not] needed to further the state's public policy

[3] Similarly, the Division has failed to mention that the MDPU approved the recovery of 100 percent of the Company's costs for the Overhead GIS survey and transformation expenses in rates. D.P.U. 09-39, at 258-263.

goals related to energy efficiency."[4] The Division further argues that "revenue decoupling will not enable or encourage the Company to pursue energy efficiency and conservation more aggressively."[5] Yet these positions are not supported by expert testimony and, in fact, are disputed by the expert testimony of Company Witness Tierney who provided substantial evidentiary support for the proposition that traditional ratemaking policies create inherent tensions between the Company's financial interests, the policy goals of the state to require pursuit of all cost-effective energy efficiency and the customer objectives to manage and lower their energy bills through implementation of energy efficiency measures.[6]

Rhode Island has established ambitious goals of procuring all cost-effective energy efficiency that will require years if not decades to achieve given the significant untapped opportunities. However, under current ratemaking policy, the Company faces a strong disincentive regarding policies and programs that reduce its energy sales, because of the adverse consequences for its revenues. The Division and TEC-RI would have the Commission pit the Company's obligations to its customers to pursue cost-effective energy efficiency against its obligations to its shareholders. Both TEC-RI and the Division fail to acknowledge the tension between customer interests and shareholder interests under the current ratemaking paradigm, and its consequences for the Company's ability to simultaneously meet aggressive energy efficiency targets, maintain investment in a reliable distribution system, and meet shareholder expectations (and thereby maintain reasonable borrowing costs). The Division and TEC-RI suggest that it is enough to simply impose laws requiring that the Company pursue all cost-effective energy efficiency, and require the Company to fulfill aggressive energy efficiency targets through

---

4 TEC-RI Initial Brief at 10.

5 Division Initial Brief at 51.

6 Tierney Direct Testimony at 21-48 (note in particular footnote 32 on pages 34-35).

Commission orders.[7] However, the implementation of revenue decoupling is a more reasoned and fair approach because it makes the Company financially indifferent to its sales levels and works toward fully aligning the Company's interests with those of its customers in managing and reducing their energy use in a way that maximizes service and minimizes costs.

For that reason, it has become widely recognized that revenue decoupling is an essential piece of regulatory policy aimed at achieving the full potential of energy efficiency programs in order to lower customer bills and achieve environmental objectives.[8] Moreover, to the extent that the Company has embraced ambitious energy efficiency goals, it is important to recognize that these goals were undertaken with the reasonable expectation that the Company would not be penalized through the continual loss of sales for achieving these ambitious goals.[9] TEC-RI and the Division would now have the Commission ignore a ratemaking mechanism that would allow the Company to achieve these goals without adverse financial affect.

The Division even goes so far as to suggest that utility energy efficiency programs are unnecessary because households and businesses will undertake energy saving measures due to the cost savings achieved by energy efficiency.[10] Although some of the Company's customers will certainly take actions to reduce energy use absent programs offered by the Company, it is well recognized that eliminating such programs would leave many opportunities for cost-effective energy efficiency untapped because of the many market failures and barriers that

---

[7] The Division argues that state law requires the Company to fund energy efficiency programs, as well as establishes standards for the implementation of least cost procurement of energy efficiency and energy efficiency measures. TEC-RI cites statements of the Company that its energy efficiency programs will be "very effective in their implementation" without revenue decoupling and that the energy efficiency programs are not going to change absent revenue decoupling." TEC-RI Initial Brief at 10-11.

[8] Tierney Direct Testimony at 28-32 (footnote 27).

[9] King Direct Testimony at 22.

[10] "Non-commercial customers will make every effort to conserve and implement efficiency programs in order to reduce commodity related costs regardless of the existence of Revenue Decoupling, … which only impacts the distribution portion of their bill." Division Brief, pages 51 to 52.

impede the adoption of many energy efficiency measures. In fact, the Commission recognized the regulated utility's important role in such efforts when it mandated procurement of all cost-effective energy efficiency.

The Division also suggests that revenue decoupling is a "minority position." However, the facts provided by the Division tell an incomplete and inaccurate story. First, use of revenue decoupling is growing. While only one state had adopted revenue decoupling for electricity in 2006, this number has grown to 5 in 2007, to 9 in 2008, and to 10 by May 2009.[11] Second, among states that have restructured their electricity industries, such as Rhode Island, the trend toward revenue decoupling is more pronounced, with five of the fifteen states other than Rhode Island having adopted revenue decoupling.[12] Third, states with aggressive and successful energy efficiency programs generally include revenue decoupling among many ratemaking and policy tools. For example, eight of the top twelve states in the adoption and implementation of energy efficiency, as ranked by the American Council for an Energy-Efficient Economy ("ACEEE"), have approved revenue decoupling.[13] Thus, among states with similar industry structures and with similar goals for energy efficiency, revenue decoupling is more the rule than the exception.

---

[11] As shown in Schedule NG-SFT-2, in 2006, only California had revenue decoupling. Additional states adopting revenue decoupling in subsequent years are as follows: for 2007, Connecticut, Idaho, Maryland, Minnesota, and New York; for 2008, Hawaii, Massachusetts, and Wisconsin; in 2009, Oregon.

[12] These states include California, Connecticut, Maryland, Massachusetts, New York. States that have restructured their electric industries (in this case, defined as significant divestment of generation assets by the vertically regulated utility) include: Delaware, Illinois, Maine, Montana, New Hampshire, New Jersey, Ohio, Pennsylvania, Rhode Island, and Texas.

[13] By ACEEE rank, these states are: **California**, **Massachusetts**, **Connecticut**, **Oregon**, **New York**, Vermont, Washington, **Minnesota**, Rhode Island, Maine, **Wisconsin**, and **Maryland** (jurisdictions in bold have approved revenue decoupling). Note that revenue decoupling for electric utilities accounts for at most 1 point out of 50 in state policy assessments. ACEEE, "The 2009 State Energy Efficiency Scorecard," Report Number E097, October 2009 (RR-COMM-15).

B. Contrary to Assertions by TEC-RI, the Company's RDR Proposal Benefits Ratepayers

TEC-RI contends that the Company's RDR plan would hurt ratepayers by shifting risk to customers, by using ratemaking with revenue adjustments that "usually end up costing the ratepayer more," and by eliminating incentives and regulatory tools for "deterring utility waste and cost inefficiency."[14] These claims miss the larger point that revenue decoupling – by allowing the state and in turn customers to fully achieve the goal of implementing all cost-effective energy efficiency – will lower customers' total payments for electricity. Even in circumstances where revenue decoupling has a "miniscule"[15] impact on customers' delivery charges, revenue decoupling in conjunction with implementation of energy efficiency leads to total overall decreased electricity bills because customers buy less power and thus avoid paying the much-larger commodity portion of their total electricity bills. The full potential of these savings can only be achieved if the Commission adopts ratemaking that removes the Company's disincentive to pursuing these opportunities aggressively.

Particular concerns raised by TEC-RI and the Division ignore the following:

- The implementation of revenue decoupling would provide the Commission with the option to eliminate back-up rates, which currently apply to large C&I customers.
- Revenue decoupling does not *shift* risk from the Company to its customers. Instead, by *fixing* total revenues to the Company and payments from customers, revenue decoupling *shares* risk between the Company and its customers. The resulting adjustments are symmetric: customer distribution rates are reduced when billed sales are higher than allowed amounts, and those rates are raised when billed sales are lower than allowed amounts. It works both ways. Under traditional rates, customers pay the Company revenues higher than the allowed revenue requirement when total usage increases relative to the assumptions in the rate case; and they pay the Company lower-than-authorized revenues when the reverse occurs.

---

14 TEC-RI Initial Brief at 13.

15 Tierney Rebuttal Testimony, Schedule NG-SFT-R-3, at page 4.

- Inflation and Cap Ex Adjustments may lead to either rate increases or decreases in future years. But, any changes would reflect changes in the underlying cost of providing service given changes in actual operating and capital expenditures. Thus, adjustments are grounded in cost-of-service principles, including that customers pay rates reflecting the cost of providing them with service.

- The Company's RDR Plan would not "weaken regulatory oversight." To the contrary, the Company's proposal provides equal or greater opportunity to review the Company's costs than is afforded by the current regulatory approach. For example, the Company's proposal would require bi-annual filings on capital expenditures that afford greater opportunity for thorough and careful review than is available through rate cases.

C. Contrary to Assertions by TEC-RI and the Division, Revenue Adjustments Complement Revenue Decoupling

The Division suggests that the Company has not demonstrated a need for a capital tracking mechanism," but its comments suggest fundamental misunderstandings with the operations and implications of proposed ratemaking adjustments. The Cap Ex Adjustment is only designed to reduce the lag in time between when investments go into service and when the costs of those investments are reflected in rates. As proposed by the Company, the design of this adjustment could either increase or decrease rates, but, in all cases, would only recover prudently incurred, used and useful capital expenditures as approved by the Commission. In an environment of rising infrastructure cost and rising investment needs, the Cap Ex Adjustment is necessary for the Company to maintain revenue growth to offset these rising costs. In fact, this would be true even if capital expenditures remain at the level included in rates. The level of capital expenditure supported by the Company's revenue requirement does not reflect (1) a return on capital expended after the end of the rate year, or (2) the actual cost of capital projects beyond the rate year, which is likely to exceed the level of depreciation expense included in rates, all else being equal. Therefore, the Company's revenue requirement will not be sufficient to support continued capital expenditures absent the Cap Ex Adjustment, especially in light of

consistently declining sales volumes occurring as a result of conservation and other economic factors.

Moreover, the Division and the Attorney General make the entirely erroneous argument that the Commission does not have the legal authority to approve an inflation factor in a utility's decoupling mechanism. Contrary to their representations, R.I.G.L. Section 39-1-27.7 permits the Company to recover "overhead and fixed costs," and as noted by the Attorney General in the definition he cited for "fixed costs," fixed costs include "salaries," which increase over time with inflation. Although "fixed costs" are constant with respect to the firm's output level or sales revenue, fixed costs are not constant from year-to-year but vary with changes in the cost of inputs. Further, this Commission has approved rate mechanisms for utilities which allow them to recover inflation on operating expenses. Order No. 18957, Interstate Navigation, Docket Nos. 3762 & 3764, at 32. In fact, the Division was a party to the settlement that the Commission approved, which allowed for the utility to raise rates annually based on inflation. Id., Appendix A (Settlement Agreement).

Lastly, the Rhode Island Supreme Court has upheld this Commission when it exercised its general ratemaking authority to set rates based on the "impact inflation will have on the costs and expenses of the Company." Providence Gas v. Burke, 475 A.2d 193, 198 (R.I. 1984). In that regard, the R.I. Supreme Court has gone so far as to declare that the Commission's decision "is intended to be a forecast of future economic events" and thus, "the commission must attempt to predict the level and effect of inflation" when it sets rates for utilities. Michaleson v. N.E. Tel. and Tel., 121 R.I. 722, 747 (1979). Thus, the Commission has ample legal authority to include an inflation factor in the RDR Plan, or to otherwise apply it to the Company's distribution rates.

Respectfully submitted,

NATIONAL GRID

By its attorneys,

Thomas R. Teehan, Esq.
National Grid
280 Melrose Street
Providence, RI 02907
(401) 784-7667

Cheryl M. Kimball, Esq. (RI #6458)
Keegan Werlin LLP
265 Franklin Street
Boston, Massachusetts 02110
(617) 951-1400

Dated: January 29, 2010