STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISISON

IN RE: NARRAGANSETT ELECTRIC COMPANY	:	
APPLICATION OF PROPERTY TAX SAVINGS	:	DOCKET NO. 2930
TO ENVIRONMENTAL RESPONSE FUND	:	

REPORT AND ORDER

I. Background/Travel

According to the Section 6(C)(1) of the Third Amended Stipulation and Settlement ("Stipulation") approved by the Commission in Order No. 16200, if an "exogenous event" (as defined in the Stipulation) occurs during a calendar year, Narragansett Electric Company ("Narragansett" or "the Company") is required to file with the Public Utilities Commission ("Commission") for a distribution rate adjustment by December 31st of that year. If Narragansett does not file for an adjustment, the Division of Public Utilities and Carriers ("Division") or other parties to Docket No. 2930 have the right to make a filing on their own to open a proceeding if they believe an exogenous event has occurred during that calendar year. The party making the filing has the burden of proving the occurrence of such an event.

However, under the Stipulation, even when Narragansett believes that no exogenous event has occurred, it has the affirmative duty to file a certification by February 1st of each year stating that, to the best of the Company's knowledge and believe, there were no occurrences of exogenous events during the prior year. If no exogenous event occurs but Narragansett saves money, that savings is credited to Narragansett's bottom line.

On March 28, 2002, Narragansett filed with the Commission a certification that to the best of its knowledge, no exogenous events occurred in 2001. On that same date,

Narragansett also filed a letter agreement between itself and the Division ("letter agreement" or "Settlement")[1] which indicated that two events occurred in 2001 which resulted in a reduction of Narragansett's tax liability to the City of Providence, Rhode Island. According to the letter agreement, one event could be interpreted as an exogenous event and the other could be interpreted as falling within the provision regarding exceptions to an exogenous event. Therefore, the letter agreement explained that rather than litigate the issue of whether the two events constituted an exogenous event, the parties agreed to interpret the events as not exogenous, but to treat the tax savings in a manner that would have the same overall effect as if the events were treated as exogenous.

On April 9, 2002, at an open meeting, the Commission addressed the issues raised in the letter agreement. The Commission noted that the certification was almost two months late, apparently because of the uncertainty regarding whether the tax savings resulted from an exogenous event. The Commission noted that although the letter agreement indicated that the service list had been noticed, only Narragansett and the Division had signed on to the letter agreement. As a result, prior to ruling on the letter agreement, the Commission allowed interested parties until April 29, 2002 to file any assertion that an exogenous event had occurred in 2001. The Commission would then hold a hearing on the issue of the tax savings and, if a filing were made, on whether an exogenous event had occurred in 2001. No party made a filing asserting that an exogenous event had occurred in 2001. Therefore, the Commission directed the parties to file testimony in support of their respective positions regarding the letter agreement.

[1] A copy of the Settlement is attached hereto as Appendix A and incorporated by reference herein.

II. The Stipulation

In defining the term "Exogenous Event," the relevant portion of the Stipulation, Section 6(B)(1), states:

> State Initiated Cost Change: Narragansett shall adjust its distribution rates (upward or downward) if the occurrence of a "State Initiated Cost Change", as defined below, causes (in the aggregate) a change in the [sic] Narragansett's revenue requirement by more than $375,000. For purposes of this Settlement, the term "State Initiated Exogenous [sic] Change" shall mean:
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> > (i) the enactment or promulgation of any new or amended state or local tax laws, regulations, or precedents governing income, revenue, sales, franchise, or property taxes or any new or amended state or locally imposed fees (but excluded the effects of annual changes in local property tax rates and revaluations).

III. Narragansett's Direct Case

In support of the proposal contained in the letter agreement, Narragansett provided the pre-filed testimony of Ronald T. Gerwatowski, former General Counsel of Narragansett Electric, Michael D. Laflamme, Manager of Regulatory Support for National Grid, USA, and Joseph M. Kwasnik, Vice President of Environment for National Grid, USA.

Mr. Gerwatowski provided an overview of Narragansett's proposal for applying tax savings to the Environmental Response Fund ("ERF"). He explained that he had been the primary person to negotiate a settlement with the Division regarding the reduction of Narragansett's tax liability to the City of Providence resulting from both an amendment to R.I.G.L. § 44-5-11.8 and a property revaluation. He indicated that the determination of whether the events that occurred fit within the definition of an exogenous event was subject to interpretation. He stated that because neither Narragansett nor the Division were certain as to the correct interpretation, they agreed upon an annual savings calculation of $2.2 million and further agreed that Narragansett

would apply the savings to the ERF, which Narragansett showed was underfunded. As part of their settlement, Narragansett and the Division agreed that all parties reserve their right to take any position in the future regarding interpretation of Section 6(B)(1) of the Stipulation.[2]

Mr. Laflamme testified that Narragansett experienced a decrease in property tax liability, due in part to the amendment of R.I.G.L. § 44-5-11.8. Mr. Laflamme explained that the statute addresses the procedures to be followed by Rhode Island municipalities to adopt a tax classification plan following a comprehensive revaluation of property values. According to Mr. Laflamme, a tax classification system is one which taxes various types of property at different tax rates. The amendment to R.I.G.L. § 44-5-11.8 mandates that the effective tax rate applicable to the highest class not exceed by more than 50% the lowest rate applicable to any other class. In order to mitigate the impact of the tax rate adjustment, Providence was allowed to phase in this requirement over a six-year period.[3]

Additionally, Mr. Laflamme explained, Narragansett has been involved in a dispute with the City of Providence regarding the assessed valuations for certain Real and Tangible Personal Property. Narragansett is claiming that valuations should be substantially reduced by the City. However, he argued that any reduction in property tax assessments resulting from the outcome of Narragansett's valuation dispute is not related to the application of R.I.G.L. § 44-5-11.8.[4]

Mr. Laflamme indicated that the analysis of Narragansett's net tax savings from the City of Providence resulting from the application of R.I.G.L. § 44-5-11.8, as amended, was complicated by the fact that the amendment was implemented in

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[2] Narr. Ex. 1 (Pre-filed testimony of Ronald T. Gerwatowski), pp. 2-5.
[3] Narr. Ex. 2 (Pre-filed testimony of Michael D. Laflamme), pp. 3-7.

conjunction with an entire property revalutation. First, assumptions would need to be made regarding the impact of the revaluation on Narragansett's tax liability. Second, it would be necessary to isolate the effect resulting from Narragansett's valuation dispute. Third, it would be necessary to predict future tax rates and attempt to determine what portion of the tax impact relates to the statutory change and what portion relates to ordinary factors affecting tax rates. Mr. Laflamme indicated that discussions with the Division made it clear that a precise calculation of the effect of the statutory change is not feasible. Therefore, the parties agreed that $2.2 million is a reasonable representation of the annual savings resulting from the tax revaluation and rate change. The settlement between the Division and Narragansett proposes that Narragansett increase funding to the environmental response fund by $2.2 million annually, commencing on January 1, 2001 and continuing through the end of 2004.[5]

Mr. Laflamme explained that the Stipulation established the ERF as a mechanism for funding recovery of Narragansett's environmental response costs related to former Manufactured Gas Plant ("MGP") sites. According to Mr. Laflamme, in accordance with Section 12(A) of the Stipulation, all "Environmental Response Costs" that have been incurred have been charged to the ERF. Likewise, all revenue recoveries and insurance recoveries related to the sites have been credited to the ERF. Additionally, $878,000 is credited annually to the fund in accordance with the Stipulation. As of June 30, 2002, however, the ERF had a deficit balance of approximately $2.8 million. Narragansett expects environmental response expenditures to increase sharply over the next several years, with a total projected deficit balance of $11,808,721 by December 31, 2004 if the

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[4] Id. at 7-8.
[5] Id. at 8-10.

proposed funding increase is not approved. With approval of Narragansett's proposal, however, the deficit balance would be reduced to $3,008,721 as of December 31, 2004.[6] Finally, Mr. Laflamme indicated that Narragansett is not proposing that the Commission approve environmental cost recovery at this time. The settlement in no way attempts to limit the Parties' rights to review or challenge any costs charged against the ERF that they believe do not fall within the definition of environmental response.[7]

Mr. Kwasnik provided background information regarding the MGPs owned by predecessors to Narragansett and the former Blackstone Valley Electric Company in Rhode Island. The MGPs were located in Pawtucket, Central Falls, Woonsocket, Bristol, Westerly and Warren. The plants were in operation from the 1860s through the early 1950s and 1960s, when pipeline natural gas was introduced into the area. The gas manufacturing process yielded large quantities of byproducts, some of which contained known or suspected carcinogenic compounds that were disposed of onsite and in offsite pits, ponds and landfills. Narragansett is responsible for the remediation of the MGP sites under state and federal law. The total expected remediation costs are approximately $100,246,000. Specifically, through 2004, Narragansett expects to expend $11,690,000 on remediation.[8]

IV. Division's Direct Case

The Division submitted the pre-filed testimony of David J. Effron, its regulatory consultant. Mr. Effron indicated that he believed the settlement between Narragansett and the Division to be appropriate and beneficial to Narragansett's ratepayers. He

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[6] Id. at 10-11. If actual spending on environmental remediation is significantly less than projected, the ERF will accrue a positive balance and interest, which the Commission may order flowed back to the ratepayers as appropriate. Id. at 12.

[7] Id. at 12.

concurred with Mr. Laflamme that $2.2 million is a reasonable representation of the annual tax savings attributable to R.I.G.L. § 44-5-11.8. He also agreed with Mr. Gerwatowski that whether the change in property tax rates constituted an exogenous event is a matter of interpretation.[9] Therefore, in his words, "[Narragansett] and the Division reached a compromise that would treat the reduction of property taxes as a non-exogenous event, but would give customers the equivalent benefits they would have received as if it were treated as an exogenous event."[10]

Mr. Effron noted that if an event is considered exogenous and causes a savings to Narragansett, ratepayers are entitled to a bill credit. However, in this case, the credit, spread over the rate base, would be minimal compared to the unavoidable rate increases in the future to cover the greater environmental remediation liability. Mr. Effron explained that the Stipulation authorizes Narragansett to recover from ratepayers reasonable and prudently incurred and properly identified remediation costs for MGP sites. Furthermore, if the annual accrual is inadequate to cover actual remediation costs incurred, Narragansett can defer any such shortfall and seek an increase in the accrual in subsequent rate cases.[11] Therefore, by increasing the accrual to the ERF, the reserve available to absorb actual environmental remediation expenditures will increase, thereby mitigating the shortfall and thus the magnitude of ratepayer liability at the end of the rate freeze period. Finally, if the issue of whether the tax savings constituted an exogenous event were to be litigated and it was determined not to be an exogenous event, the credit would go to the bottom line for investors, subject to the earnings sharing provisions in the

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[8] Narr. Ex. 3 (Pre-filed testimony of Joseph M. Kwasnik), pp. 3-8.
[9] Division Ex. 1 (Pre-filed testimony of David J. Effron), p. 3.
[10] Id. at 4.
[11] Id. at 5.

Stipulation. Therefore, Mr. Effron opined that contesting the issue would create a risk with no potential reward.[12]

V. Hearing and Supplemental Agreement

A public hearing was held at the Commission's offices, 89 Jefferson Boulevard, Warwick, Rhode Island, on September 20, 2002 to assess the propriety of the Settlement between Narragansett and the Division. The following appearances were entered:

FOR NARRAGANSETT:	Thomas Robinson, Esq.
FOR DIVISON:	Paul J. Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Cynthia G. Wilson, Esq. Senior Legal Counsel

The parties explained that the $2.2 million was a compromise figure. Mr. Effron explained that in attempting to isolate the effect of the legislation (i.e., the amendment to R.I.G.L. § 44-5-11.8) on the property taxes from one year to the next, given all of the variables, one thing that becomes important is to determine the sequence that is assumed in calculating the savings relative to the legislation as opposed to any other factor. He elaborated by giving an example to show that if the effects of the legislation were assumed to occur first and the effects of the revaluation were assumed to occur second, the savings would be very different than if the assumptions were reversed. Therefore, in effect, the parties agreed to split the difference in their compromise.[13]

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[12] Id. at 5-6.

[13] Tr. 9/30/02, pp. 18-20. At the time of the hearing, a case was pending in the Providence County Superior Court, challenging the property revaluation. The Settlement between the parties would be effective despite the outcome of the trial. However, the Division indicated that based on the information at the time of the Commission hearing, it was comfortable with the effect of the Settlement. According to Mr. Effron, even if Narragansett realizes more savings than anticipated, the majority of the savings would ultimately accrue to the benefit of ratepayers through the earnings sharing mechanism in any case. Id. at 21-23.

Addressing the fact that it is so difficult to determine the actual savings for each future year, Mr. Effron explained that if the tax savings for a given year is less than the agreed-upon $2.2 million, Narragansett will still credit the ERF with $2.2 million. If the savings is more, the excess will be used to reduce Narragansett's ongoing expenses and will be factored into the calculation of the earnings sharing going forward.[14]

The parties indicated that they anticipated the credit to the ERF to continue only through the end of the rate freeze period because the assumption was that either Narragansett would file a rate case or the Division would initiate a filing if Narragansett is over-earning.[15] However, in response to concern expressed from the Bench that the ERF credit would cease at the end of the rate freeze period even if tax savings continued to accrue to Narragansett, during a recess the parties created a formula against which to measure the continuation of tax savings for purposes of crediting the ERF.[16] This agreement was subsequently memorialized in writing and filed on October 7, 2002 ("Supplemental Agreement").[17]

The Supplemental Agreement states:

> Narragansett may elect to stop the additional $2.2 million credit to the Environmental Response Fund during the period following the Rate Freeze Period and until the effective date of its next base rate change if it demonstrates that the Company's last total property tax bill for real and tangible property from the City of Providence is greater than $6.3 million.

In order to reach the Supplemental Agreement, the parties started with the 2001 Providence property tax bill, totaling $10 million, as a benchmark. From this amount, they deducted an amount equal to the $2.2 million credit to the ERF plus a compromise

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[14] Id. at 20-21.
[15] Id. at 28-32.
[16] Id. at 39-51.

sum in place of the expected savings from the pending tax litigation in Providence County Superior Court, leaving a balance of $6.3 million.[18] If Narragansett's tax liability exceeds $6.3 million following the end of the rate freeze period, Narragansett may file evidence with the Commission and Division to show that the conditions of the Supplemental Agreement permitting a termination of the ERF credit have been met.[19] Under questioning from the Bench, the Division's witness conceded that the Supplemental Agreement "may marginally be of greater benefit" to ratepayers. Mr. Effron also indicated that he had "been assuming all along that because of the time frame of the rate freeze and the really significant changes that have been going on during the rate freeze that there would have to be some kind of rate review anyway at the end of the rate freeze."[20]

Finally, Narragansett agreed to refile its calendar year 2001 earnings statement to reflect the $2.2 million adjustment to the ERF.

VI. Post-Hearing Information Request

Following the hearing, the Commission issued the following post-hearing information request to the parties:

> Why the $2.2 million ERF credit should not be applied in full through the end of the first post-rate freeze rate case, given the fact that the parties have indicated that ratepayers are in substantially the same position they would be in had the property tax change been treated as an exogenous event. The question cited footnote 3 on page 14 of the Third Amended Stipulation and Settlement, which states in relevant part: "Any Exogenous Event adjustments made during the Rate Freeze Period will remain in rates through to the completion of the Company's first COS rate case."

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[17] A copy of the Supplemental Agreement is attached hereto as Appendix B and incorporated by reference herein.

[18] Id. at 39-41. It is important to note that the parties were not calculating an estimated litigation savings, but rather, were taking the Division's calculation of litigation impact and dividing it in half to take into account the fact that the ERF credit is applied first. Id. at 44-45.

[19] Id. at 45-46.

[20] Id. at 46-47.

In its response, the Division stated that the $2.2 million credit to the ERF should not simply continue in full through the first COS rate case after the rate freeze period regardless of the magnitude of the Providence tax bills because this is not what would happen if the reduction to the property taxes in 2001 were treated as an exogenous event. According to the Division, if the property tax reduction were treated exactly like an exogenous event, it would have been necessary to re-evaluate the effect of R.I.G.L. § 44-5-11.8 on the Company's property tax expenses every year and to adjust the credit or charge accordingly to determine if the Company were no longer receiving a savings from the change in law. The fixed $2.2 million credit, combined with a fixed benchmark against which to measure whether Narragansett is still experiencing a tax savings, eliminates the expense an administrative burden and annual re-evaluation would entail.

The Division also contended that the parties to Docket 2930 never intended any exogenous events adjustment to continue through the end of the first post rate freeze period COS rate case without a yearly determination of the savings. The Division pointed out that if an exogenous event had increased the Company's expenses, the Division would have wanted to review the effect annually to protect ratepayers from paying more than their liability. Therefore, according to the Division, the agreed-upon treatment puts ratepayers in substantially the same position they would be in if the property tax savings were treated as an exogenous event.

In its response, Narragansett indicated that under the Stipulation, if an exogenous event had occurred and a refund factor or surcharge had been implemented, either the Company or the Division would need to refile with the Commission each year during the

term of the Rate Freeze Period to request any change in the refund factor (or surcharge) reflecting any changes since the implementation of the refund factor (or surcharge).

According to Narragansett, the agreement to fix the credit at $2.2 million insulates ratepayers from a fluctuation that reduces the savings. Furthermore, Narragansett stated, the Supplemental Agreement establishing a $6.3 million benchmark against which to measure the tax savings potentially allows the ratepayers to receive the ERF credit beyond the rate freeze period. It was Narragansett's position that this agreement alleviates the need for an annual determination of tax savings, which would become increasingly difficult and administratively burdensome to determine.

VII. Commission Findings

On November 6, 2002, at an Open Meeting, the Commission considered the evidence presented and voted unanimously to approve the Settlement between Narragansett and the Division, as modified by the Supplemental Agreement. The ERF was established under the Stipulation as a mechanism for funding the recovery of MGP site remediation costs incurred by Narragansett. To the extent that such costs are reasonably and prudently incurred, and appropriately identified as "environmental response costs" (as defined in the Stipulation), they are recoverable from, and thus become the obligation of, the ratepayers. According to Narragansett, the ERF accrual currently allowed in Narragansett's base rates is insufficient to recover the actual remediation costs incurred by Narragansett. Unless this underfunding of the ERF is addressed, the projected growth in environmental remediation costs during the rate freeze period will likely result in future rate increases for customers. Therefore, we find that mitigation of the ERF shortfall, in the manner prescribed by the parties in the Settlement

and the Supplemental Agreement, is in the best interests of the ratepayers, because it will reduce the environmental response costs to be recovered from ratepayers after the rate freeze period ends.

Specifically, the Settlement credits the $2.2 million tax savings directly to this future ratepayer obligation in lieu of an immediate, but *de minimus*, bill credit. One hundred percent of the ERF credit is thus entirely traceable to the benefit of ratepayers. Moreover, a review of the testimony in this case indicates that on balance, the impact on each ratepayer of a *de minimus* bill credit in the near term would be outweighed by the impact of the increased customer obligation in the future. Application of the annual $2.2 credit to the ERF, however, will reduce that obligation by nearly $8 million during the rate freeze period. Moreover, the Supplemental Agreement provides the additional assurance that ratepayers will continue to receive the benefits of the tax savings – even after the rate freeze period ends on December 31, 2004 – unless and/or until that savings is depleted below the agreed upon level.

Having reviewed the responses submitted to the Commission's post-hearing information request, the Commission is persuaded by the arguments of Narragansett and the Division as to why the $2.2 million ERF credit should not be applied through the end of the first post-rate-freeze cost of service rate case without regard to the magnitude of the tax savings after the rate freeze period. In addition to the arguments of the parties regarding whether the benefit is being applied over the same time period as if it were truly an exogenous event, and notwithstanding the language of footnote 3 on page 14 of the Stipulation, the Commission notes that page 12 of the Stipulation (part of the exogenous event section) states the following: "Any adjustments…shall be collected

through a uniform and fully reconciling surcharge or refund factor…." Arguably, under this provision, a reconciliation filing could be required each year to determine the continued level of savings or expense.

This issue was also partially addressed at the February 29, 2000 hearing in this docket. During questioning from the bench, Narragansett explained that if the exogenous event were a recurring event, Narragansett would require a recurring surcharge or refund whereas, if the event were not a recurring event, the surcharge or refund would not stay in rates. Using a tax change that required a surcharge as an example, Narragansett agreed that even if it did not file a rate case until 2007, it would still collect the surcharge until the end of that rate case because the costs would still be there. However, Mr. Gerwatowski stated that if the costs disappeared, the surcharge could be adjusted out. In fact, the Company is required to file for such an adjustment during the rate freeze period. On the other hand, it also appears from the Company's testimony that if the exogenous event (or the effects thereof) expired after the rate freeze period, there is no requirement for the Company to file for an adjustment to the surcharge. According to the Company, however, it would presumably become apparent through its filed earnings reports that there was no longer a need for the surcharge. The burden thus shifts to the Division or the Commission to initiate a proceeding to challenge the continuation of the surcharge after the rate freeze period.[21]

Therefore, the Commission believes that the parties' Settlement, as modified by the Supplemental Agreement, puts ratepayers in substantially the same position (if not a more certain position) as if the change in tax liability were treated as an exogenous event. The major difference is that rather than having to determine the effect of the tax change

each year, the parties have agreed to a benchmark against which to measure the effect of the tax change. The benchmark is reached when Narragansett's tax liability to the City of Providence exceeds $6.3 million. As aptly stated by the Company, "[t]he Agreement locks in a savings of $2.2 million per year through the rate freeze period and, under the Supplemental Agreement reached on September 20, 2002, potentially beyond the rate freeze period of total taxes in the City of Providence do not exceed $6.3 million."[22] Consequently, even if Narragansett's tax liability for a year is $6.29 million, the ratepayers would still receive the benefit of a $2.2 million credit to the ERF, although Narragansett's tax savings for that year is less than $2.2 million. Finally, we point out that, under the Settlement as originally filed, the ERF credit would simply have ceased at the end of the rate freeze period, even if the tax savings continued to accrue to Narragansett. Under the Supplemental Agreement, however, termination of the ERF credit after the rate freeze period is conditioned upon an affirmative showing by the Company that its total tax liability to the City of Providence has exceeded the benchmark. This provision ensures that ratepayers will continue to receive the benefit of the tax savings even after the rate freeze period ends, until the Company's satisfies its burden of proof on this issue.

Accordingly, it is hereby

(17354) ORDERED:

1. The Settlement filed on March 28, 2002 between Narragansett Electric Company and the Division of Public Utilities and Carriers, as modified by the Supplemental Agreement filed on October 7, 2002, is hereby approved.

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[21] Tr. 2/29/00, pp. 157-164.

2. In accordance with the terms of the Settlement and the Supplemental Agreement, Narragansett shall credit an additional $2.2 million per year to the Environmental Response Fund commencing January 2001, and continuing annually thereafter until the effective date of its next base rate change following the first cost of service rate case after the rate freeze period; *provided however*, that Narragansett may discontinue the credit after the rate freeze period ends upon a showing that its total property tax bill for real and tangible property from the City of Providence is greater than $6.3 million.
3. Narragansett Electric Company shall refile its calendar year 2001 earnings statement within thirty (30) days of this Report and Order to reflect the initial $2.2 million credit to the Environmental Response Fund.
4. Narragansett Electric Company shall comply with all other findings and instructions contained in this Report and Order.

EFFECTIVE AT WARWICK, RHODE ISLAND PURSUANT TO AN OPEN MEETING DECISION ON NOVMBER 6, 2002. WRITTEN ORDER ISSUED JANUARY 29, 2003.

PUBLIC UTILITIES COMMISSION

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Elia Germani, Chairman

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Kate F. Racine, Commissioner

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Brenda K. Gaynor, Commissioner

[22] Narragansett's Response to Commission's Post-Hearing Request dated October 7, 2002, p. 2.