STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: NEW ENGLAND GAS COMPANY'S :
DISTRIBUTION ADJUSTMENT CLAUSE : DOCKET NO. 3459

REPORT AND ORDER

I. NEGAS' AUGUST 1, 2002 FILING

On August 1, 2002, the New England Gas Company ("NEGas"), a division of Southern Union, filed updated factors to the Distribution Adjustment Clause ("DAC") for effect November 1, 2002.[1] In addition, NEGas filed a factor, associated with the conclusion of Providence Gas Company's ("ProvGas") Energize Rhode Island Extension Settlement Agreement ("ERI II"), to be included in the proposed DAC.[2] NEGas' proposed DAC would decrease the bill for the average residential heating customer of the former Valley Gas and Bristol & Warren Gas Companies' ("Valley") service territory by 52 cents per year. Also, NEGas' proposed DAC would increase the bill for the average residential heating customer of the former ProvGas service territory by $16.77 per year.

In support of its filing, NEGas submitted pre-filed testimony by Peter Czekanski. Mr. Czekanski explained that the DAC includes an annual system pressure factor related to liquefied natural gas ("LNG"), a Demand Side Management ("DSM") factor, a Low Income Assistance

[1] In Docket No. 3401, the Commission approved DAC as part of the NEGas Merger Rate Settlement Agreement in Order No. 17381.

factor, an Environmental Response Cost ("ERC") factor, an On-System Credit relating to non-firm margins and a Weather Normalization Adjustment ("WNA") factor. Mr. Czekanski noted that NEGas is not updating the DSM or Low Income Assistance components because NEGas is not proposing any change to the level of funding established and built into base rates as result of Docket No. 3401. As for the On-System credit or WNA components, Mr. Czekanski stated that there will not be any credits or debits to incorporate into DAC until the end of the first year under the Settlement Agreement in Docket No. 3401.[3]

As for the system-pressure factor, NEGas proposed a reduction in the factor to $0.0032 per therm. This factor is based on the commodity related portion of LNG costs. These commodity costs related to LNG are based on NEGas' calculation for its Gas Cost Recovery Clause ("GCR") filing of June 3, 2002 in Docket No. 3436. In regards to the ERC factor, NEGas proposed a reduction in the factor of $0.0002 per therm. This reduction is based on the inclusion of fiscal year 2002 data that was not available at the time of Docket No. 3401 and a $1.7 million reduction to the ERC account made by Southern Union, the parent company of NEGas.[4]

As outlined in Mr. Czekanski's testimony, the ERI II Settlement Agreement established a Deferred Revenue Account ("DRA") that at the

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[2] In Docket No. 2581, the Commission approved the ERI II Settlement Agreement in Order No. 16584.

[3] NEGas Ex. 1: (Czekanski's direct testimony) pp. 3-5.

end of the ERI II term credited or debited ratepayers. The components of the DRA were: earnings in excess of 10.7 percent return on equity ("ROE"); exogenous events, and weather mitigation. In addition, there are non-firm margin sales. The sales and transportation customers would be credited 75 percent of non-firm margins that exceeded $1.2 million while the Company would retain the remaining 25 percent. Therefore, the Company proposed to use the DAC to address the DRA balance and the sharing of non-firm margins accrued during the term of ERI II.

Mr. Czekanski informed the Commission that two elements of the ERI II Settlement Agreement in Docket No. 2581 are included in the proposed DAC: weather mitigation and non-firm margins. He explained that the weather mitigation clause provides for crediting/debiting the DRA at the rate of $7,800 per degree day in the November through April period. During the first winter under the ERI II Settlement, November 2000 through April 2001, there were 102 degree days in excess of the threshold. Therefore, $795,600 was credited to the DRA. He states that during the second winter under the ERI II Settlement, November 2001 through April 2002, the weather was warmer than normal and there were 579 degree days in excess of the threshold. Therefore, it is his testimony that $4,516,200 is being debited to the DRA. Also, Mr.

[4] Id., pp. 5-7.

Czekanski stated that the Company did not have earnings in excess of 10.7 percent ROE nor were there any exogenous events.[5]

The calculation of non-firm margins was explained. Also, the amounts available for sharing with customers from non-firm margins under the ERI II Settlement were described. During the period October 2000 through September 2001, the first 12 months of ERI II, NEGas recorded $1,067,777 of non-firm margins; $132,223 less than the $1.2 million threshold. Accordingly, Mr. Czekanski stated that there were no non-firm margins available for sharing between customers and NEGas. For the period October 2001 through June 2002, the last nine months of ERI II, NEGas indicated it had $1,267,360 of non-firm margins. Prorating the $1.2 million threshold for this nine-month period resulted in a threshold of $950,309. Under this scenario, $237,789 of margin was shared with the customers. Mr. Czekanski indicated that the net result of the ERI II DRA and the non-firm margin sharing was an increase of $4,278,411 or $0.0167 per therm to the DAC to customers in the former ProvGas service area. Only former ProvGas customers received this increase.[6]

II. DIVISION'S SEPTEMBER 30, 2002 FILING

On September 30, 2002, the Division filed testimony by David Effron, a consultant. Mr. Effron stated that he would address the development of the ERI II Adjustment component of the DAC; in

[5] Id., pp. 8-9.

particular, the determination of the excess earnings element of the ERI II Adjustment. He also addressed the ERC being proposed by the Company.

Mr. Effron discussed his calculation of $2,687,000 of excess earnings by ProvGas during the ERI II period. He stated that any excess earnings should be credited to the DAC for ProvGas customers effective November 1, 2002, and that any approval of the ERC factor should not be construed as a finding that the environmental costs are prudent or reasonable. Mr. Effron stated that NEGas did prepare an analysis of its ROE over the term of ERI II and that a preliminary review of its earnings from October 1, 2002 through June 30, 2002 has been completed. He stated that NEGas calculated an ROE of 11.36% for the twelve (12) months ending September 30, 2002 and 9.34% of the twelve (12) months ending June 30, 2002, and that since the average return on common equity for these two twelve (12) month periods was less than 10.70%, NEGas concluded there should be no credit to the DRA for excess earnings during the term of ERI II.[7]

Based on his examination of NEGas' calculation of its ROE for the period October 1, 2002 through June 30, 2002, Mr. Effron stated that NEGas should modify its calculation. He determined that there should be several modifications that would affect both the determination of net income and the common equity supporting the utility rate base used in

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[6] Id., pp. 9-11.

the calculation of the ROE. First, for the income tax expense, he used the federal income tax rate of 35% in determining operating income instead of the 38% "pro forma" federal income tax rate used by NEGas. Second, Mr. Effron stated that NEGas had reclassified $455,000 of "below the line" income tax expense to operating expenses but provided no explanation of why it is appropriate to include this item in the operating expense. Finally, Mr. Effron concluded that to calculate net income for available common equity, the interest expense must be subtracted from the net operating income.[8]

Also, Mr. Effron proposed adjustments to the interest expense calculated by NEGas. He stated that the ERI II Settlement Agreement specifies that the interest expense is to be calculated by multiplying the rate base by the percentage of debt in the capital structure times the applicable cost rate. He proposed an adjustment to the rate base computed by NEGas, which he said would affect the interest expense, and proposed to modify the cost of debt used in the calculation of the interest expense. In regards to the capital structure, Mr. Effron stated that NEGas assumed that the 50% debt in the capital structure was entirely long-term debt, but that the ERI II Settlement Agreement did not limit the 50% debt in the capital structure to long-term debt. Further, he testified that he believed that the intent was to include a

[7] Div. Ex. 1 (Effron's direct testimony), pp. 3-5.
[8] Id., pp. 5-7.

mixture of long-term and short-term debt in the capital structure since this method has traditionally been used.

Mr. Effron stated that he assumed that 41.6% of the 50% debt in the capital structure is long-term debt, consistent with the capital structure presented for ProvGas in Docket No. 3401, and that the remaining 8.4% of the 50% of debt consists of short-term debt. He used a cost rate of 4.86% because that was the short-term debt recommended by Division witness Matthew Kahal in Docket No. 3401.[9]

Further, Mr. Effron stated that he calculated net income of $13,188,000 available for common equity for the twelve (12) month period ending September 30, 2001, and that this amount should be divided by the balance of common equity to determine the earned return on equity. Mr. Effron proposed modifications to the rate base. He determined that since neither the rate base calculations accompanying the ERI I quarterly reports nor the rate base determination in Docket No. 2286 included prepaid expenses in rate base, the inclusion of prepaid expenses in rate base is not consistent with established Commission ratemaking principles for ProvGas. Therefore, Mr. Effron concluded that the prepaid expenses should be eliminated from rate base and that this reduction to rate base reduces the common equity used to calculate the ROE. With his changes to the net income available for common equity and the balance of common equity, he calculated

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[9] Id., pp. 7-8.

that ProvGas earned a 12.82% return on common equity for the twelve (12) month period ending September 30, 2001. For the twelve (12) month period ending June 30, 2002, Mr. Effron recalculated the earned return on common equity generally utilizing the same modifications as used for the twelve (12) month period ending September 30, 2001, with the exception of his proposed adjustment to operating expenses.[10]

Mr. Effron stated that his proposed adjustment to operating expenses is the elimination of the share of these expenses allocable to ProvGas from the utility operating expenses incurred during the twelve (12) month period ending June 30, 2002. Additionally, he pointed out that one of the areas still being investigated is the administrative and general ("A&G") expenses incurred for the twelve (12) month period ending June 30, 2002. For that period, he stated that $29.2 million was incurred by ProvGas for A&G expenses, including corporate allocations. Mr. Effron stated that ProvGas recorded an increase of approximately 45% over its A&G expenses occurred for the twelve (12) month period ending September 30, 2001, before the acquisition of Southern Union. He noted that in Docket No. 3401, however, the Company represented that the acquisition would result in substantial reductions, not increases, to operation and maintenance expense, including A&G.[11]

With Mr. Effron's changes to the net income available for common equity and the balance of common equity, he calculated that ProvGas

[10] Id., pp. 8-10.

earned a 10.48% return on common equity for the twelve (12) months ending June 30, 2002. He also calculated the excess revenue for the 21-month period from October 1, 2000 to June 30, 2002. He determined that the weighted average annual return on common equity for this 21-month period was 11.65%, which exceeded the ceiling of 10.70% by 0.95% and resulted in excess income of $977,000 per year. Mr. Effron stated that since the term of ERI II was 1.75 years, excess income over this term amounts to $1,710,000. Consequently, $2,687,000 represents excess earnings over the term of ERI II.

Pursuant to the Settlement in Docket No. 3401, Mr. Effron stated that excess revenue should be credited to the DAC applicable to customers of the former ProvGas. He determined that, based on sales of 256,410,000 therms, this credit will reduce the DAC for former ProvGas customers by $0.0105 per therm.[12]

After a review of the NEGas' computations of the ERC factor, Mr. Effron stated that the ERC factor is a credit. Beginning November 1, 2002, he said the Company is seeking to recover less than the $1,310,000 embedded in base rates for environmental response costs. Further testimony by Mr. Effron states that there should be one small correction to increase the costs recovered in rates through June 30, 2002 by $12,312, which he feels does not change the ERC factor of ($0.0002) per therm. He did not propose any modifications, but

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[11] Id., pp. 10-11.

indicated that no review or analysis of the costs of the environmental projects for which NEGas is seeking recovery has been conducted to verify the prudence and reasonableness of those costs. He recommended that if implementation of the ERC factor calculated by NEGas is approved, the Commission should make clear that it is not making a finding that the costs of the environmental projects incurred through June 30, 2002 are prudent or reasonable or that a review of such costs in the future is precluded.[13]

III. NEGAS' OCTOBER 11, 2002 FILING

On October 11, 2002, NEGas filed surrebuttal testimony in response to the Division's testimony of David J. Effron relating to the ROE calculations under the ERI II Settlement Agreement approved by the Commission in Docket No. 2581. The testimony was filed by Sharon Partridge, a Vice President for the New England Gas Company.

Ms. Partridge testified that the Company calculated the return on equity for the twelve (12) month periods ending September 30, 2001 and June 30, 2002 in accordance with the ERI II Settlement Agreement. She stated that the resulting average return on equity for the combined periods totaled 10.4% which is below the 10.7% authorized by ERI II. Ms. Partridge also testified that she did not agree with Mr. Effron's modifications to NEGas' ROE calculation nor did she agree to Mr. Effron's adjustment to the federal income tax rate used in calculating

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[12] Id., pp. 11-12.

the ProvGas' earnings in the two 12-month reporting periods. She specifically stated that Mr. Effron's adjustment to substitute the federal tax rate for the actual effective tax rate applicable to NEGas' earnings in the two 12-month reporting periods under evaluation is not consistent with the provisions of the ERI II Settlement Agreement. Ms. Partridge stated that these provisions are expressly designed to enable the Company to "accurately report earnings" for the two reporting periods.

Relative to the ERI II Settlement Agreement, Ms. Partridge argued that, unless otherwise noted in the Settlement Agreement, the intent of the ERI II earnings-sharing calculation is to accurately identify ProvGas' earnings in the two periods under evaluation. Therefore, she further argued, there is no basis for the application of the federal tax rate to ProvGas' earnings. According to her testimony, Southern Union files a consolidated tax return for its local distribution operations and, as a result, the federal tax rate applicable to ProvGas' earnings in the two 12-month reporting periods is the rate paid by Southern Union.[14]

Ms. Partridge questioned the second adjustment Mr. Effron made to the interest rate used by NEGas in calculating ProvGas' earnings relative to the ROE. She stated that since no determination has been made in a ratemaking proceeding since the merger, the appropriate cost of debt has not been addressed. Ms. Partridge did not accept

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[13] Id., pp. 12-13.
[14] NEGas' Ex. 2 (Partridge's surrebuttal testimony), pp. 1-4.

Mr. Effron's proposal to rely on the weighted cost of debt (7.38%), which was based on an analysis of a proxy group.

Furthermore, Ms. Partridge noted that the Commission made no findings of fact with respect to Mr. Kahal's testimony in Docket No. 3401 relative to weighted cost of debt of 7.38%. Accordingly, she felt there is no basis for the Commission to rely on Mr. Kahal's calculations in the instant proceeding. Because no determination on the appropriate use of cost of debt for the Company has been made, Ms. Partridge stated that 7.87% is the best estimate of the Company's cost of debt, as previously used by ProvGas.[15]

In her surrebuttal testimony, Ms. Partridge disagreed with Mr. Effron's adjustment to remove prepayments from rate base in calculating ProvGas' earnings. She argued that ProvGas is allowed to include prepayments in its calculation of rate base. She asserted that Mr. Effron's analysis of the appropriate use of cost of debt only relied on quarterly report filed pursuant to ERI I and the rate base determination in Docket No. 2286. She stated that the documentation associated with the ERI I Settlement has no bearing on the calculations required by the ERI II Settlement. She further stated that the Commission's order approving the ERI II Settlement Agreement did not state that ratebase would be calculated based on ERI I quarterly reports, and even though prepayments may have been excluded from the ERI I Settlement, their

[15] Id., pp. 5-6.

earnings calculations are irrelevant. Ms. Partridge concluded that there is no basis for the exclusion of prepayments from ratebase and that Mr. Effron does not question that the prepayments are accurately calculated.[16]

Furthermore, Ms. Partridge stated that Mr. Effron made other adjustments that are incorrect, including the removal of $72,000 from operation expenses for the 12-month period ending June 30, 2002. She conceded that the removal of these expenses is subject to dispute, but noted that Mr. Effron did not remove these expenses from actual incurred costs. Ms. Partridge indicated that the removal of these costs only from the calculation of the Operation and Management ("O&M") expense cap would have no impact on the earnings calculation for the period because ProvGas' actual O&M expenses exceeded the cap set forth in the ERI II Settlement Agreement by over $1.3 million.[17]

Finally, Ms. Partridge argued that there is no basis for Mr. Effron's calculation in the ERI II Settlement Agreement of a 1.75 year excess income multiplier. Rather, she stated that to calculate the return on equity for the two 12-month reporting periods, the ERI II Settlement Agreement states that the earnings report will use an average of the return on equity for the 21-month period. She noted that the ERI II Settlement Agreement further indicated that any earnings in excess of 10.7%, excluding ProvGas' incentive portion of non-firm margins, will be

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[16] Id., pp. 6-7.

credited to the DRA. Ms. Partridge interpreted a two-step process in the ERI II Settlement: 1) The ROE is calculated for each of the two reporting periods and then is averaged together to establish the allowed return; and 2) any ROE above the average return of 10.7% is subject to the sharing mechanism. Ms. Partridge asserted that there is not a third step for a 1.75 multiplier and, therefore, there is no basis for this adjustment.[18]

IV. DIVISION'S OCTOBER 21, 2002 FILING

On October 21, 2002, the Division filed the supplemental testimony of David J. Effron. Mr. Effron stated that the purpose of his testimony was to update the calculation of over-earnings since NEGas submitted its final ERI II earnings reports on September 27, 2002. He indicated he was responding to the surrebuttal testimony of Sharon Partridge dated October 11, 2002. Mr. Effron testified that the Division did not have enough information at the time of his supplemental filing, and, therefore, should be allowed to continue investigating ProvGas' operations for the ERI II period while recognizing the over-earnings determined to date.

Mr. Effron revised his calculation of the ROE for the twelve (12) months ending September 30, 2001 and the twelve (12) months ending June 30, 2002. Using NEGas' final ERI II earnings report, Mr. Effron calculated a ROE of 14.41% for the twelve (12) months ending

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[17] Id., pp. 7-9.

September 30, 2001 and 8.73% for the twelve (12) months ending June 30, 2002. He stated that his calculation of 11.58% of the weighted average annual ROE exceeded the ceiling of 10.70% by 0.88% resulting in excess income of $893,000 per year. According to Mr. Effron's calculations, for the term of ERI II (1.75 years), this resulted in excess income over this term of $1,562,000 which translated into excess revenue of $2,455,000 over the term of ERI II. [19]

Mr. Effron proposed increasing the revenue for each of the 12-month reporting periods by $362,000 to reflect the funding of Integrated Resource Plan ("IRP") programs (Low-Income Assistance Program to be funded at an annual level of $1.3 million for each year of the extended term; Demand Side Management rebate program to be funded at an annual level of $0.3 million; and Low-Income Weatherization Program to be funded at an annual level of $0.3 million for the first year and $0.2 million for the second year). According to Mr. Effron, the earnings reports prepared by ProvGas show charges against revenue of $2,212,000 for funding IRP programs for each twelve month reporting period although the average annual level of funding allowed for these programs under the ERI II Settlement Agreement is $1,850,000.

Mr. Effron stated that the ProvGas charges against revenue for the IRP programs differ from the $1,850,000 per year as specified in the ERI II Settlement Agreement for several reasons. First, he said, ProvGas

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[18] Id., pp. 8-9.

included the incremental commitment of $250,000 from Docket Nos. 1673 and 1736 in the charges against revenue. Since this increased commitment was intended to be a contribution from shareholders, Mr. Effron argued that the $250,000 should be eliminated from the cost of the IRP programs charged against revenues. Second, he stated that NEGas double counted the Low-Income Assistance Program costs for the three months of the two 12-month reporting periods that overlap and that this should result in a correction of IRP costs charged against revenues by ProvGas to $1,850,000 per year.[20]

Mr. Effron stated that Ms. Partridge repeatedly referred to 35% as the ProvGas income tax rate. He asserted that this is not a proper description and that he used the statutory federal income tax rate applicable to all corporate taxpayers with taxable income in excess of $10 million. Mr. Effron further testified that his reliance on the income tax rate used in the earnings report of 35% is proper. He cited Docket No. 2581 and the testimony of James DeMetro and Mr. DeMetro's accompanying exhibit. Also, Mr. Effron indicated that NEGas used the statutory tax rate, not an effective tax rate, for the purpose of calculating the federal income tax expense included in the cost of service in Docket No. 3401. The effect of Southern Union's non-deductible expenses, which the 38% tax rate would be used for, has nothing to do with ProvGas' operations, according to Mr. Effron. Mr. Effron stated

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[19] Div. Ex. 2 (Effron's supplemental testimony), pp. 1-2.

that subsequent to the acquisition of ProvGas by Southern Union, it is clear that the statutory federal income tax rate was intended to be the appropriate tax rate for ratemaking purposes.

Furthermore, Mr. Effron testified that, in his experience, the Commission has always used the statutory federal income tax rate to determine the income tax expense to be included in the cost of service for ratemaking purposes. He also stated that, based on his experience, the Commission has never used an effective income tax rate as described by Ms. Partridge. Therefore, he argued that the effective tax rate described by Ms. Partridge would not be consistent with established Commission ratemaking principles and would violate the ERI II Settlement Agreement.[21]

Mr. Effron attempted to clarify his position relative to the weighted cost of debt. He stated that he did not know the basis for Ms. Partridge's claim that he proposed to rely on the weighted cost of debt (7.38%) suggested by the Division's witness, Mr. Kahal, in Docket No. 3401. He stated that he did not modify the cost of long-term debt used by the Company in its earnings reports. He did note, however, that he proposed including short-term debt in the capital structure and, therefore, that he agreed with Mr. Kahal's testimony in Docket No. 3401 in this regard.[22]

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[20] Id., pp. 2-4.
[21] Id., pp. 4-6.
[22] Id., pp. 6-7.

Also, Mr. Effron disagreed with the inclusion of prepayments in rate base because that would be inconsistent with established Commission ratemaking principles for ProvGas. According to Mr. Effron, neither rate base calculations accompanying the quarterly reports filed pursuant to the ERI I Settlement nor the rate base determination in Docket No. 2286 included prepaid expenses in rate base. He denied that the exclusion of prepayments from rate base in those reports was inadvertent; noting that Ms. Partridge did not cite Commission precedent in this matter and, therefore prepayments should not be included in rate base.[23]

Mr. Effron agreed with Ms. Partridge's objection to the elimination of $72,000 from operation expenses for the twelve (12) months ending June 30, 2002 because the removal of this sum does not affect the calculation of the ROE since the actual operation and maintenance expense for the twelve (12) month period was higher than the capped expense included in the earnings report.

Mr. Effron disagreed with Ms. Partridge's interpretation that under the ERI II Settlement Agreement an investigation of the A&G expense category will not have any impact on the earned return calculation. He testified that the language in the ERI II Settlement cited by Ms. Partridge excluded any pro forma adjustments such as those for wage rate changes. If A&G expenses included costs that were not

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[23] Id., p. 7.

recoverable from ratepayers pursuant to established Commission ratemaking principles then he determined the elimination of such costs would be permitted and required by the ERI II Settlement Agreement.[24]

Furthermore, Mr. Effron explained that it is appropriate to multiply the annual rate of excess earnings by 1.75. He stated that the ROE calculation reflected the income for a one-year period divided by the average balance on common equity for that same period. Also, he argued that the ERI II Settlement Agreement did not explicitly state that the annual rate of excess earnings (if any) would be multiplied by 1.75 only because it is self-evident that such a step is necessary to calculate the amount of excess revenue applicable to the ER II term of 1.75 years.

If the ERI II Settlement were in effect for only one year and the ROE for that one year was 11.58%, Mr. Effron testified that it would not be necessary to multiply the excess earnings by the term of the plan to determine the excess earnings for the period. He stated that it then follows that if ERI II was actually in effect for 1.75 years and the average earned return on equity for that 1.75 period was 11.58%, then the average annual excess earnings during that period must be multiplied by 1.75 to calculate the excess earnings over the entire 1.75 year term.[25]

Mr. Effron stated that $2,455,000 did not represent the Division's final determination of excess earnings for ProvGas during the term of the ERI II Settlement because ProvGas' final ERI II earnings report,

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[24] Id., pp. 7-9.

which was submitted on September 27, 2002, generated additional potential issues that the Division was still in the process of analyzing. Furthermore, he stated that the Division was still investigating the A&G expenses for the twelve (12) months ending June 30, 2002.

Based on the results of the investigation to date, the Division recommended that the DAC should reflect a credit of $2,455,000 for excess revenues earned by ProvGas over of the ERI II period. Mr. Effron stated that if the continuing investigation by the Division leads to a determination that over-earnings were actually greater over the term of ERI-2, then any additional excess revenue, as well as any appropriate interest from November 1, 2002, should be credited to the DAC effective November 1, 2003.[26]

V. OCTOBER 22, 2002 HEARING

After public notice, the Commission conducted a hearing on October 22, 2002 at its offices on 89 Jefferson Boulevard, Warwick. The following appearances were entered:

FOR NEGAS:	Craig Eaton, Esq. Cheryl M. Kimball, Esq.
FOR DIVISION:	Paul J. Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Steve Frias, Esq. Executive Counsel

[25] Id., pp. 9-10.
[26] Id., pp. 10-11.

NEGas presented as witnesses Mr. Czekanski and Ms. Partridge. Under cross-examination from the Division, Ms. Partridge could not explain an attachment to her testimony that she used to support the use of an effective tax rate of 38 percent. In response to the question: "it's fair to say that you cannot testify to the underlying detail that makes up the numbers on SP-1", Ms. Partridge stated: "That's absolutely correct."[27] Ms. Partridge stated that ProvGas is "a division and not a separate company", so it cannot generate its own tax rate calculation. She admitted that ProvGas doesn't have its own federal income tax rate. In response to the question that "the ERI II Settlement Agreement doesn't specify the use of an effective tax rate", Ms. Partridge stated: "That's absolutely correct."[28]

As for the $1.7 million adjustment to the ERC account, Ms. Partridge explained that after a review of the invoice relating to the Allens Avenue site, Southern Union "thought maybe some of the fees related to some consulting work … was higher than they thought should have been done at that site and as a result made the decision to write off approximately 1.7 million of the cost". Also, Ms. Partridge understood that Commission approval of the ERC factor does not mean that the Commission has determined that the costs incurred were prudent.[29] Ms. Partridge stated she was not aware if prepayment expenses were

[27] Tr. 10/22/02, pp. 14-15, 18.
[28] Id., pp. 20, 24, 26.
[29] Id., pp. 35-36.

included in the rate base for Docket No. 2286 or in the ERI I Settlement.[30]

After questioning from the Commission's fiscal analyst, Ms. Partridge admitted that without the 1.75 multiplier, NEGas would retain earnings above 10.7 percent ROE. As for the inclusion of the environmental response costs into the rate base, Ms. Partridge stated the Commission order "doesn't have a finding" regarding the issue and that "Mr. Hogan's testimony" is only "in the travel of the order".[31] Ms. Partridge admitted in reference to the ERI II Settlement that "no members of the committee that would have been involved in the settlement are active employees of New England Gas".[32]

As for the Division's proposed 1.75 multiplier, Ms. Partridge stated that: "It isn't that I oppose it, I didn't see any need to even consider the multiplier". Furthermore, in response to Commission Counsel's question: "are you opposed to using any calculation based on trying to annualize", Ms. Partridge stated that: "That was the intent." She admitted that if earnings are calculated on an annual basis then the 1.75 factor is appropriate.[33]

The Division presented Mr. Effron as its witness. Mr. Effron stated that the language relating to environmental response costs in the ERI II

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[30] Id., p. 44.
[31] Id., pp. 46-47, 71-73. On October 21, 2002, one day before the hearing, NEGas filed a revised final ProvGas earnings report for the ERI II period, which included environmental response costs in the rate base.
[32] Id., p. 115.
[33] Id., p. 41-43.

Settlement is identical to the language in the Narragansett Merger Rate Settlement, and therefore, these costs are not includable in rate base.[34] Mr. Effron stated that the statutory tax rate was applied to ProvGas in prior dockets and in Docket No. 3401. He also indicated that prepayments were not included in rate base in Docket No. 2286 or in the ERI I Settlement.[35]

Under cross-examination from NEGas' counsel, Mr. Effron stated that the ProvGas' letter dated August 2, 2000 was the "company's description of the settlement". He also related that the "Commission never applied an effective tax rate".[36] Under redirect examination, Mr. Effron indicated that Mr. Hogan's testimony in Docket No. 2581 was referring to the treatment of environmental response costs in the ERI I Settlement.[37]

Under further cross-examination from the Division's counsel, Ms. Partridge stated ProvGas does not generate true taxable income because it is not "a separate entity any longer" because it is "a division, not a subsidiary".[38] Under questioning from Commission Counsel, counsel for NEGas admitted that Ms. Partridge indicated that various aspects of the ERI II Settlement were silent. Counsel for the Division indicated that typically the utility drafts settlement agreements.

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[34] Id., pp. 149-152.
[35] Id., pp. 153, 156.
[36] Id., pp. 182, 184.
[37] Id., pp. 192-194.
[38] Id., pp. 208-209.

Counsel for NEGas agreed that if there is an ambiguity in an agreement, under contract law, the benefit of the ambiguity goes to the party who did not draft the agreement.[39] At an open meeting on October 24, 2002, the Commission suspended NEGas' proposed DAC from going into effect and allowed for briefs by the parties.

VI. POST-HEARING BRIEFS

A. NEGAS

On November 12, 2002, NEGas filed its post hearing brief. NEGas argued that the Division's adjustments for the ERI II earnings calculations were inappropriate. NEGas maintained that the ERI II Settlement is "silent or ambiguous on a number of critical components" as to earnings calculations. Utilizing contract law, NEGas indicated that the first step is to determine if the terms are clear and unambiguous. To determine if it is clear and unambiguous, the agreement should be reviewed in its entirety and the language given the plain, ordinary and usual meaning. If it is clear and unambiguous, the terms are applied as written. The agreement is ambiguous if it is reasonably susceptible to more than one interpretation. If the terms are ambiguous, extrinsic evidence is allowed to interpret the agreement. Therefore, NEGas indicated that in order to interpret the ERI II Settlement, the Commission can review the evidence in Docket No. 2581 regarding the

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[39] Id., pp. 208-210.

ERI I Settlement, the terms and operations of the ERI II Settlement, and Commission ratemaking precedent.[40]

On October 21, 2002, NEGas had filed a correction to the earnings sharing calculation to include the actual cash expenditures for environmental response costs in the rate base, asserting that accrued and actual cash expenditures were included in the rate base under the ERI II Settlement. In response to Division data requests in Docket No. 2581 regarding ERI II calculations, ProvGas had stated it would exclude accrued environmental expenses from the balance of Accumulated Depreciation. In addition, NEGas noted that at the hearing reviewing the ERI II Settlement, Mr. Hogan, ProvGas' witness, discussed the inclusion of actual cash expenditures in the rate base. Furthermore, NEGas noted that the Commission's order discussed Mr. Hogan's testimony relating to environmental response costs.[41]

NEGas argued that Section G of the ERI II Settlement relating to environmental response costs was only an attempt to create a separate account. Also, NEGas disagreed with the Division's argument that Mr. Hogan's testimony at the hearing in Docket No. 2581 only referred to the treatment of environmental response costs in the ERI I Settlement.[42]

As for the prepaid expenses, NEGas stated that in the NEGas Merger Rate Settlement only prepaid taxes are excluded from the

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[40] NEGas Post-Hearing Brief, pp. 4-7.
[41] Id., pp. 7-9.
[42] Id., pp. 9-12.

earning-sharing calculation. Also, NEGas argued that the Commission has included prepayments in rate base in other utility rate proceedings. Furthermore, NEGas argued that even if ProvGas did not include prepayments in rate base calculations, this has no bearing on whether Southern Union, during the term of ERI II would have incurred those prepayments.[43]

Regarding the tax rate applied to earnings, NEGas argued that ProvGas merged into Southern Union on September 28, 2000, and that it operates as a division of a corporation and not as an independent subsidiary. Thus, NEGas explained that "since the date of the merger for both financial reporting and income tax purposes" the "financial results of the ProvGas operations have been consolidated with those of Southern Union". In other words, Southern Union has paid the income taxes. NEGas suggested that in Docket No. 2286 and Docket No. 3401, the Commission used the effective tax rate to compute earnings calculations.[44]

For IRP expenses, the NEGas maintained that the $250,000 contribution for LIHEAP should not be excluded because it did reduce earnings. NEGas maintained it did not double count the Low-Income Assistance Program costs. Finally, NEGas stated that the 1.75

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[43] Id., pp. 13-14.
[44] Id., pp. 14-18.

multiplier is not included in the ERI II Settlement for earnings calculations and therefore should not be utilized.[45]

B. DIVISION

On November 12, 2002, the Division filed its post-hearing brief relating to six areas: income tax rate, interest rate, prepayments, IRP accruals, period of excess earnings, and environmental remediation expenditures. In regards to the income tax rate, the Division stated that the Commission has always used the 35% statutory federal tax rate to calculate federal income tax expense. The Division stated that the 38% effective income tax rate for Southern Union was inappropriate, and noted that Ms. Partridge could not explain how the 38% effective income tax rate was calculated. The Division emphasized that the ERI II Settlement states that operating results "will be adjusted to reflect Commission ratemaking principles".[46]

In the area of the interest rate, the Division stated that the ERI II Settlement did not limit the debt in the capital structure to long-term debt, but should include a mixture of long-term and short-term debt.[47] As for prepayments, the Division noted that the rate base for earnings calculation must be consistent with "established Commission ratemaking principles". The Division noted that in neither Docket No. 2286 nor the ERI I Settlement were prepaid expenses in the rate base.[48]

[45] Id., pp. 18-21.
[46] Division's Post-Hearing Brief, pp. 2-3.
[47] Id., pp. 3-4.
[48] Id., pp. 4-5.

As for IRP accruals, the Division noted that the ERI II Settlement at Section F provides for an average annual level of funding of $1.85 million. However, ProvGas' earnings reports charged $2,212,000 against revenues for the IRP program, an increase of $362,000. The Division opposed this increase both because it reflects an attempt to charge against revenues the $250,000 contribution from shareholders to ProvGas LIHEAP customers, and a double counting of the Low Income Assistance Program costs for the three months of the two 12-month periods that overlap.[49]

As for the period of excess earnings, the Division noted that Ms. Partridge found the Division's calculation using the 1.75 multiplier to determine excess earnings over a 21-month period to be mathematically correct. The Division noted that Ms. Partridge's opposition to using the 1.75 multiplier would allow ProvGas to retain earnings over 10.7 percent. The Division urged that the 1.75 multiplier be utilized in order to allow for a proper earnings calculation over the 21-month ERI II period.[50]

Addressing environmental remediation expenditures, the Division noted that on September 27, 2002, NEGas filed what it characterized as "the final ERI-2 earnings report", whereas on October 21, 2002, one day before the hearing, certain revisions to these final reports were filed. At the last minute, NEGas determined that the environmental response

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[49] Id., pp. 5-6.

expenditures should be included in rate base. The Division pointed out that NEGas argued there was an ambiguity regarding the issue because during the hearing reviewing the ERI II Settlement, Mr. Hogan, using the past tense, described how environmental response costs were included in the rate base. However, the Division emphasized that Section G of the ERI II Settlement clearly states that "no interest shall accrue on debit balances", and that including environmental response costs in the rate base would cause ProvGas to receive a return on these costs. The Division noted that both Ms. Partridge and the former General Counsel of ProvGas had acknowledged that the ERI II Settlement regarding treatment of environmental remediation expenses "was consistent with the Commission's treatment of similar expenditures in the electric industry". Accordingly, the Division emphasized that the language in the ERI II Settlement relating to environmental response costs is identical to the Narragansett Merger Rate Settlement.[51]

VII. POST-HEARING AFFIDAVITS

On November 12, 2002, NEGas filed an affidavit of Kenneth W. Hogan. Mr. Hogan stated that under the ERI I Settlement, actual and accrued environmental remediation costs were included in the rate base but in the ERI II Settlement, only actual environmental remediation costs were included in the rate base.[52]

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[50] Id., pp. 6-8.
[51] Id., pp. 8-10.
[52] Hogan Affidavit

On November 18, 2002, the Division filed a motion to strike Mr. Hogan's affidavit, or in the alternative, to accept the affidavit of David Effron. Mr. Effron indicated that the Environmental Response Fund in the ERI II Settlement is the only mechanism to fund the recovery of environmental response costs and that no interest shall accrue on debit balances. Mr. Effron noted that inclusion of the debit balance in the rate base would provide for the funding through the overall rate of return.[53] On November 22, 2002, NEGas objected to the Division's motion to strike.

VIII. NEGAS SETTLEMENT WITH THE DIVISION

Prior to proceeding with further litigation, NEGas and the Division engaged in settlement discussions. On January 16, 2003, the NEGas filed a letter with the Commission indicating it had reached a settlement with the Division ("Division's DAC Settlement"). On February 4, 2003, the Division's DAC Settlement was filed with the Commission. In the DAC settlement, NEGas agreed to reduce the $4,278,411 weather normalization adjustment by $2,455,000 resulting in a rate increase of $1,823,311. Additionally, the parties agreed to clarify certain language in the NEGas Merger Rate Settlement. First, the parties agreed that neither accruals nor actual cash expenditures for environmental response costs would be included in rate base. Second, the parties agreed that the revenue used to determine earnings will not include

[53] Effron Affidavit

unbilled revenue. Third, NEGas agreed that it will not make an adjustment to the accrued liability for IRP programs as a result of the Division's DAC Settlement.[54]

IX. FEBRUARY 6, 2003 HEARING

After notice, the Commission conducted a public hearing on February 6, 2003, at its offices in Warwick, Rhode Island. The parties presented Ms. Partridge and Mr. Effron to testify in support of the DAC Settlement. Counsel for NEGas indicated that he did not consider Mr. Effron an expert in reviewing settlement agreements. Furthermore, counsel for the Division stated that Mr. Effron is not an expert on judging the justness and reasonableness of a settlement "because that is the job and only the job of the Commission."[55]

Under cross-examination from Commission Counsel, Mr. Effron concurred with the definition of "actual" utilized in Black's Law Dictionary.[56] Mr. Stephen Scialabba, the Division's Chief Accountant, admitted he supervised the Division's case in Docket No. 3401. Mr. Scialabba read the answer of Mr. Kahal, the Division's capital structure expert in Docket No. 3401, at the May 6, 2002 hearing. The question asked of Mr. Kahal was: "Another approach is the actuals of the merged companies in New England, i.e., Valley and Providence. Do you see that as anproach is aos-af Mr.hinke thatdatan is n longder

usable?" In response, Mr. Kahal stated: "That's no longer available to us, unfortunately, and that's because New England Gas Company is not an independently financed company. It's financially integrated with Southern Union Company. Southern Union Company will serve as the source of capital for New England Gas Company operations in the future. New England Gas Company is not going to go out and issue its own debt or its own common stock." Mr. Scialabba found the statement to be accurate.[57]

Ms. Partridge admitted she was a NEGas witness in Docket No. 3401. She read the direct pre-filed testimony of Mr. Dunn, NEGas' capital structure expert in Docket No. 3401, filed on November 1, 2001. She read the question presented in Mr. Dunn's testimony which asked: "Can individuals make a direct investment in the New England Gas Division?" Ms. Partridge reviewed Mr. Dunn's answer which stated: "The process of investment in the New England Division involves investment in Southern Union because the New England Division is a division of Southern Union and is not a separate publicly traded corporation. Capital, in the form of debt and equity, is supplied by individuals and institutions to Southern Union." Ms. Partridge did not disagree with Mr. Dunn's statement.[58]

Mr. Effron attempted to suggest that the actual capital structure available to the Commission in Docket No. 3401 for ratemaking was not

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[57] Id., pp. 35, 37-38.

Southern Union, but NEGas, which was purportedly 100 percent equity. Mr. Scialabba read the pre-filed testimony of Mr. Kahal submitted on March 5, 2002, which stated: "The traditional approach to capital structure in Rhode Island is to utilize the actual capitalization data of the regulated utility. New England Gas Company is a division and does not have an identifiable capital structure. It is financially integrated with Southern Union Company. The present circumstances suggest two potential approaches to a capital structure. The first would be to use the actual capital structure for Southern Union. The second is the use of a hypothetical capital structure". Mr. Scialabba acknowledged that the reference to actual capital structure in Docket No. 3401 is Southern Union. When asked if there was any discussion in Docket No. 3401 regarding ProvGas having an actual capital structure of 100% equity, Mr. Scialabba stated: "I don't remember".[59]

Mr. Scialabba also reviewed the Merger Settlement which stated: "The settling parties agree that it is the intent of this settlement that acquisition premiums and ownership by the parent company not distort future cost of capital determination for either ProvGas, Valley Gas and/or Bristol and Warren, or their successor or assignee. Therefore, prospectively, the companies will propose the following alternatives for establishing an appropriate capital structure and associated capital cost rates for use in establishing rates for gas distribution service: Southern

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[58] Id., pp. 40-41.

Union's actual, consolidated capital structure, its embedded debt and preferred equity cost rates, and a reasonable cost of common equity consistent with this capital structure and financial market and economic conditions at that time; and a capital structure that reflects the capital structure for a comparable group of local gas distribution companies similar in risk to ProvGas, Valley and/or Bristol and Warren or their successor or assignees on a stand alone basis, along with cost rates for sources of capital that are consistent with this capital structure and financial market and economic conditions at that time". Mr. Scialabba agreed that the reference to actual capital structure in this document was to Southern Union.[60]

At the hearing, Mr. Effron initially indicated that ProvGas became a subsidiary after the merger but later indicated he was unaware if ProvGas remained a separate corporation or became a division. In response to the question of whether ProvGas is a division and a part of NEGas, counsel for NEGas responded: "I don't know". Counsel for the Division stated that the only corporate entity in existence is Southern Union.[61]

Mr. Effron indicated if the Southern Union actual capital structure was utilized for ProvGas' earnings calculations, the over earnings to be returned to ratepayers would be greater. Accordingly, the

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[59] Id., pp. 41-44, 46.
[60] Id., pp. 49-51.
[61] Id., pp. 56-58.

Division was requested to perform a ProvGas earnings calculation utilizing the Southern Union actual capital structure.[62] Counsel for NEGas indicated that the ERI II Settlement had "clear language", and stated in response to a question regarding Commission interpretation of settlements that the Commission should look at "the clear language of the settlement and what the intent of the parties were to the settlement".[63]

Mr. Effron indicated that he was unaware of a state commission that relied on the capital structure of the parent company to set a capital structure of a division or a subsidiary. Mr. Effron stated that a capital structure can be determined from a balance sheet although "it might not be the capital structure you would want to use for establishing rates."[64]

Ms. Partridge testified that, included in the ProvGas' 2001 annual report filed with the Commission, is a balance sheet indicating that ProvGas had 100 percent equity. When asked if he had considered the use of Southern Union's capital structure in the ERI II Settlement, Mr. Effron stated: "I don't know whether that was even considered or not…I'm sure at least the thought crossed my mind during that time."[65] Ms. Partridge noted the footnote on the balance sheet in the ProvGas 2001 annual report stating that, as a result of the merger, ProvGas no

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[62] Id., pp. 82-83.
[63] Id., pp. 80, 83-85.
[64] Id., pp. 100, 111.

longer has capital stock. Mr. Effron admitted that the phrase "common stock" and "common equity" is "sometimes" used by "the parties or the Commission loosely in a non-technical fashion".[66] At the conclusion of the hearing, the Commission voted to reject the Division's DAC settlement and proceed with litigation.[67]

X. DIVISION'S FEBRUARY 19, 2003 TESTIMONY

On February 19, 2003, The Division filed the additional supplemental testimony of David Effron. He addressed the calculation of over-earnings and the capital structure used by the Division in its calculation of the ProvGas ROE after reviewing the final ERI II earnings report submitted on September 27, 2002. Mr. Effron calculated a return on common equity of 13.10% for the twelve (12) months ending September 30, 2001 and 10.85% for the twelve (12) months ending June 30, 2002. According to his testimony, the weighted average annual return on common equity for this 21-month period was 11.98%, which exceeds the ceiling of 10.70% as specified in the ERI II Settlement by 1.28% and results in excess income of $1,302,000 per year. Since the term of ERI II was 1.75 years, he stated that excess income over this term was $2,279,000, which translates into excess revenue of $3,582,000.

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[65] Id., pp. 116, 119-121.
[66] Id., pp. 122-124.
[67] Id., p. 129. Chairman Germani abstained on this motion.

Mr. Effron stated that his updated calculation of the ROE includes the same adjustments to NEGas' position that were addressed in his direct and supplemental testimony. He stated that he also eliminated all deferred environmental response costs, including unamortized actual cash expenditures, from rate base because the inclusion of these deferred costs in rate base would be inconsistent with the ERI II Settlement Agreement.[68]

In his additional supplemental testimony, Mr. Effron proposed to modify the unbilled revenue, included by NEGas in total revenues, for each of the two twelve (12) month periods as well as the allowance for funds used during construction ("AFUDC") in income for each of the periods. He explained that because ProvGas bills its customers on a cycle basis at the end of any given month, customers receive gas for which they are not billed. He further described this service as "unbilled" since ProvGas has not billed for the service as of the end of each month, even though it does provide the gas and has earned revenue for the commodity. According to Mr. Effron, ProvGas determined the balance of unbilled revenue at the end of any given month as estimated based on purchased gas volumes, injections to and withdrawals from inventory, assumed line losses, and other relevant factors. He stated that at the end of any given month, the unbilled revenue is for a full month of usage for a customer whose meter was last read on the first day of that

[68] Div. Ex. 9 (Effron's additional supplemental testimony), pp. 1-3.

month and zero for a customer whose meter was read on the last day of that month. He then reasoned that for the customer base as a whole, the balance of unbilled revenue at the end of the month should reflect about one-half of the "send-out" for that month.

The unbilled revenue included in total operating revenues in a given period, according to Mr. Effron, represents the change in the balance in unbilled revenue from the beginning of the period to the end of the period. He stated that if the balance is higher at the end of the period than at the beginning, the amount included in total operating revenue will be positive. By contrast, he stated that if the balance is lower at the end of the period, the unbilled revenue included in total revenue will be negative. Accordingly, Mr. Effron believed that NEGas included unbilled revenue in its statement of income in the earnings reports filed pursuant to the ERI II Settlement. He calculated the unbilled revenue for the twelve (12) months ending September 30, 2001 as a positive of $2,467,000 and the unbilled revenue for the twelve (12) months ending June 30, 2002 as a negative of $3,237,000.

Because the balance of unbilled revenue as of the end of a given month is based on estimates, Mr. Effron indicated that these unbilled revenue amounts should be adjusted. He stated that if the estimates of the balances are erroneous, then the unbilled revenue over a given period of time will also be erroneous. Based on his review of the NEGas estimates, he believed the unbilled revenue is not reliable.

Mr. Effron stated that NEGas estimated the balance of unbilled sales was 651,439 mcf as of the end of business on June 30, 2001, which is the starting point for the second twelve (12) month period of the ERI II period. Mr. Effron further stated that the total send-out for the month of June 2001 was 543,301 mcf. According to NEGas' estimates, he stated that the balance of unbilled sales as of the end of June 2001 was greater than the total send out for the month. Mr. Effron concluded that if NEGas bills all of its customers on a monthly basis, this scenario is not possible. Under this premise, he stated that the bills rendered in June would cover at least part of the volumes sent out in that month as well as any balance of unbilled sales at the end of May. Also, according to his testimony, the remaining unbilled balance at the end of June would have to be less than the send-out for the month.

Likewise, Mr. Effron indicated that NEGas estimated that the balance of unbilled sales as of September 30, 2001 was 627,444 mcf and that the total send-out for September 2001 was 581,244. Therefore, Mr. Effron stated that the estimate of the unbilled sales at the end of the month is greater than the total send-out for the month. He concluded that this is not possible if the meters are read monthly.

Therefore, Mr. Effron recommended that the balances of unbilled revenue as of June 30, 2001 and September 30, 2001 be modified. He suggested that the balances as of June 30, 2001 and September 30, 2001 be set at the average of the balances of September 30, 2000 and

June 30, 2000, or $2,534,000. As a result, Mr. Effron stated that the unbilled revenue in the first twelve (12) month period should be decreased by $2,733,000 and that unbilled revenue in the second twelve (12) month period should be increased by $2,971,000.[69]

Furthermore, Mr. Effron described Construction Work in Progress ("CWIP") as the cumulative balance of expenditures of plant in the process of being constructed but not yet complete. Since NEGas has included CWIP in the balance of "plant in service" in rate base, Mr. Effron stated that AFUDC should also be included in operating income. He explains that AFUDC represents the carrying cost accrued on CWIP while the plant is under construction. According to the NEGas Merger Rate Settlement Agreement in Docket No. 3401, Mr. Effron stated that NEGas was permitted to include CWIP in rate base for the purpose of calculating its earned return as long as the AFUDC accrued on that CWIP was included in operating income. He concluded that including AFUDC would increase NEGas' operating income by $433,000 for the twelve (12) months ending September 30, 2001 and by $232,000 for the twelve (12) months ending June 30, 2002.[70]

Relative to capital structure for the purpose of calculating the ROE, Mr. Effron used 50% debt (of which 8.4% is short-term debt and 41.6% is long-term debt) and 50% equity. He stated that the ERI II

[69] Id., pp. 3-6.
[70] Id., pp. 6-7.

Settlement Agreement provided for the Company to use this approach in calculating the capital structure.

After examining the balance sheets included in the reports filed by ProvGas, Mr. Effron stated that he determined the actual average common equity ratio of ProvGas was above 50%. His examination confirmed that ProvGas' capital structure has been affected by the merger with Southern Union. His testimony was that ProvGas ceased to be a separate corporation and became a division of Southern Union after the merger. He also stated that the outstanding debt of ProvGas became an obligation of Southern Union and was replaced by capital from Southern Union that was not reflected as long-term debt on the ProvGas' balance sheet. Therefore, following the merger, Mr. Effron stated that the actual capital structure of ProvGas for financial reporting purposes was 100% equity and, hence, he used a capital structure consisting of 50% debt and 50% equity to calculate the earned return on equity during the term of ERI II.

Since Southern Union still has capital invested in ProvGas and that capital appears as equity on the balance sheet of ProvGas, Mr. Effron testified that equity in ProvGas does not cease to exist just because it ceases to exist as a separate corporation. He further stated that the Division was aware that ProvGas would cease to exist as a separate corporation and would become an operating division of Southern Union. However, he stated that the ERI II Settlement

Agreement allowed for only two possible alternative capital structures to be used in calculating the earned return on equity. The first is the actual ProvGas capital structure if the common equity ratio is 50% or less. The second is a capital structure consisting of 50% debt and 50% equity if the actual ProvGas capital structure contains more than 50% common equity.

Mr. Effron testified that a footnote to the ProvGas balance sheet as of December 31, 2001 indicated that ProvGas no longer had capital stock outstanding subsequent to the merger with Southern Union. He stated that this does not mean, however, that ProvGas did not have a capital structure or equity. He explained that capital stock is not synonymous with equity and that any business enterprise with a balance sheet will have a balance of equity representing the residual difference between the assets and liabilities of the enterprise. He also described the net investment the equity represents relative to the net investment by the corporate parent in that division if the enterprise is an unincorporated division of a larger corporation. According to Mr. Effron's testimony, he believed that if a division has its own financial statements, including a balance sheet, then it will also have an identifiable balance of equity.

Mr. Effron stated that he did not use the Southern Union consolidated capital structure to calculate the ROE earned by ProvGas. He stated that the ERI II Settlement Agreement is very clear on this

point and that the actual capital structure of ProvGas was to be used in the ROE calculation unless ProvGas' actual average common equity ratio was above 50%. Mr. Effron testified that if the debt of ProvGas remained on its balance sheet subsequent to the merger, the capital structure would have been approximately 60% equity and 40% debt. He concluded that a capital structure consisting of 50% debt and 50% equity would be used to calculate the earned return on equity in those circumstances based on the ERI II Settlement Agreement.[71]

Mr. Effron summarized his testimony by stating that he calculated that based on the actual ROE ProvGas earned $3,582,000 in excess of the hard cap of 10.70% over the ERI II term. Therefore, with the modifications in his additional supplemental testimony, Mr. Effron reduced the ERI II Adjustment Factor from $0.0167 per therm to $0.0027 per therm, and reduced the DAC Factor for customers of the former ProvGas from the $0.0873 per therm proposed by NEGas to $0.0733 per therm.[72]

XI. NEGAS' MARCH 21, 2003 TESTIMONY

On March 21, 2003, NEGas filed responsive testimonies by Kenneth Hogan and John Reed. On behalf of NEGas, Mr. Kenneth W. Hogan stated that the purpose of his testimony was to respond to issues raised by the Commission regarding the appropriate capital structure to be used in the calculation of ProvGas' earnings under the ERI II

[71] Id., pp. 7-11.

Settlement Agreement. Mr. Hogan served as Senior Vice President of Finance and Administration for ProvGas as well as for the New England Division of Southern Union Company. Prior to his tenure at ProvGas, Mr. Hogan was employed by Valley Resources, Inc. ("Valley) as Senior Vice President, Chief Financial Officer and Secretary.

Mr. Hogan recalled that at the time the ERI II Settlement Agreement was being negotiated, it was agreed to among the parties to the settlement that, following the merger with Southern Union, ProvGas would become an operating division within the Southern Union organization. He stated that under the provisions of the Merger Settlement Agreement, ProvGas would be required to maintain separate books of accounts, including income statements, assets, liabilities and equity. Under this scenario, Mr. Hogan affirmed that ProvGas would continue to report its own common equity levels that would then be incorporated into the earnings calculation under the ERI II Settlement Agreement. According to Mr. Hogan's testimony, if ProvGas became an operating division of Southern Union, the parent company would assume the debt obligations of ProvGas and the average common equity ratio reported by ProvGas could be increased significantly by both the elimination of debt and the increase in equity due to the Goodwill (acquisition premium) that would be assigned to the ProvGas operating division. He stated that the calculation of the ROE, as designed by the

[72] Id., p.12.

parties to the ERI II Settlement Agreement, would not bear additional costs associated with the substantial increase in the average common equity ratio on the books of ProvGas. He recalled that the parties agreed not to use the actual common equity of ProvGas but rather a ratio of common equity applicable to rate base.

Mr. Hogan stated that the ERI II Settlement Agreement was intended to allow ProvGas and its customers to maintain a status quo with respect to both earnings and costs until the rate consolidation plan was put in place. Therefore, he recalled that the parties agreed that ProvGas would calculate an appropriate ROE for ProvGas during the ERI II period using ProvGas' "actual capital structure and associated costs of capital" during that time period. He further stated that this scenario would require the use of a capital structure that was 50% equity and 50% debt if ProvGas' actual average common equity ratio recorded on its books during either reporting period exceeded 50%.[73]

Furthermore, Mr. Hogan stated that ProvGas entered into a Settlement Agreement with the Division regarding a change to the interest rate applied to the deferred gas costs in the ProvGas Gas Charge Clause tariff. Pursuant to the Deferred Gas Cost Settlement, the calculation of ROE in the earnings report filed with the Commission by ProvGas would be modified to reflect the use of short-term debt to fund deferred gas costs. Specifically, Mr. Hogan referred to ProvGas'

[73] NEGas Ex. 9 (Hogan's responsive testimony), pp. 2-6.

requirement to adjust the short-term debt portion of the capital structure to exclude that portion of the average short-term debt balance associated with the average deferred gas cost balance. He stated that the adjusted capital structure is required to be used for calculation of common equity applicable to rate base and return on common equity.

Mr. Hogan argued that the Deferred Gas Cost Settlement does not affect the calculation of ProvGas' capital structure for purposes of this proceeding. He stated that even when calculating ProvGas' actual capital structure during the ERI II period, consistent with the Deferred Gas Cost Settlement, the capital structure during this period consisted of an average common equity ratio that well exceeded 50%. He concluded by stating that if Southern Union's capital structure were to be imputed by the Commission, the provisions of the Deferred Gas Cost Settlement relating to the use of short-term debt in the capital structure would apply.[74]

John J. Reed, Chairman and Chief Executive Officer of Commonwealth Energy Advisors, also filed testimony on behalf of NEGas. He provided his views on two issues relative to capital structure. First, he offered his analysis in determining ProvGas' earnings under the earning cap being reviewed in the current proceeding. Second, he provided a more general determination of the capital structure to be used to establish a utility's weighted average cost

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[74] Id., pp. 6-7.

of capital for ratemaking purposes. Additionally, he discussed Southern Union's corporate structure, the ERI II Settlement Agreement, industry standards with regards to capital structure and rate of return, and the implications of using Southern Union's capital structure for purposes of determining the rate of return for ProvGas.[75]

According to Mr. Reed, a utility's cost of capital is comprised of the weighted average of its cost of debt, cost of preferred stock and allowed return on common equity. The utility's weighted average cost of capital is then applied to its allowed rate base to derive its allowed return.[76]

In this proceeding regarding capital structure, Mr. Reed stated that his interpretation of the ERI II Settlement is that the parties agreed that the 50/50 debt/equity default capital structure should be used for purposes of calculating ProvGas' ROE under the earnings cap. Mr. Reed concluded that the use of the default 50/50 debt/equity capital structure is appropriate and that its use is: consistent with the capital structure used to set base rates in effect for ProvGas during the ERI II period; consistent with the Division's merger order excluding Southern Union's acquisition premium from rate base; just and reasonable in comparison to other gas distribution utilities of comparable risk; and consistent with the requirements and expectations of the financial community for ProvGas, New England Gas and Southern Union.

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[75] NEGas Ex. 10 (Reed's responsive testimony), pp. 1-2.

Conversely, Mr. Reed stated that use of Southern Union's capital structure would: deny ProvGas the opportunity to earn a reasonable return since refunds under the earnings cap would be determined in a matter inconsistent with the basis on which rates were established; significantly increase ProvGas' financial risk without adjusting the earnings cap for the corresponding increases in equity and debt costs; improperly includes capitalization associated with unregulated operations and the acquisition premiums resulting from Southern Union's acquisitions of various regulated utilities; be inconsistent with the capital structures for comparable natural gas and local distribution companies of similar risk; send a clear message to the energy and financial communities that the Commission believes that a short-term rate reduction is more important than allowing ProvGas and New England Gas to continue as investment-grade entities; and have the overall effect of expropriating earnings that rightfully should be retained by the ProvGas operations.[77]

Mr. Reed stated that the capital structure to be used in utility ratemaking should enable a company to attract capital at reasonable rates as well as represent a level of financial risk that is consistent with the risks that investors would incur in "comparable" investments and reasonably represents the amounts and means by which regulated assets are financed. He indicated that these basic policies have been

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[76] Id., p. 2.

fundamental to ratemaking principles in both state and federal jurisdictions for decades. Furthermore, he noted that since the financial risks created by highly-leveraged capital structures result in higher debt and equity cost rates, it is important to employ a capital structure that reasonably represents the assets financed and the risk and return expectations of investors. Therefore, Mr. Reed argued that in instances where a company has a capital structure that is not representative of a regulated gas utility, the use of a proxy capital structure is reasonable.[78]

Mr. Reed explained that the capital structure adopted in the ProvGas' 1995 rate case was the basis of the capital structure used in the ERI I and ERI II Settlements. He stated that the Commission ordered ProvGas to use its actual capital structure as of May 31, 1995 to calculate its ROE. At that time, Mr. Reed said the capital structure was: 51.7% of common equity, 5.5% of preferred equity; 40.0% of long-term debt, and 2.7% of short-term debt.

According to Mr. Reed, the Division-approved Merger Settlement did contemplate that there could be issues with using Southern Union's capital structure for the purpose of establishing rates prospectively. For instance, one approach was to use a capital structure that reflects the capital structures for a comparable group of local gas distribution companies. Mr. Reed noted that in Docket No. 3401 both the Division's and NEGas' witnesses proposed the use of a capital structure derived

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[77] Id., pp. 3-4.

from capital structures of a proxy group of companies. Furthermore, in Docket No. 3401, the Division's witness, Matthew Kahal, stated that Southern Union's common equity ratio was below 30% and thus, the use of the Southern Union's capital structure would be "unduly" weak and inappropriate for ratemaking.[79]

In addition, Mr. Reed argued that the capital structure of a newly-merged company has been addressed in Rhode Island previously. He indicated that on March 3, 2000, Narragansett Electric, Blackstone Valley Electric, and Newport Electric Corporation entered into a merger rate settlement agreement with the Division, the Attorney General, the Navy and TEC-RI. He noted that this Narragansett Merger Rate Settlement provided for an imputed a capital structure of 50% common equity, 45% debt and 5% preferred stock, and was approved by the Commission on March 14, 2000. According to Mr. Reed, the capital structure established in the ERI II Settlement is consistent with the capital structures that were adopted in the Division-approved Merger Settlement, the NEGas Merger Rate Settlement, and the Narragansett Merger Rate Settlement.[80]

Mr. Reed stated that if the Commission used Southern Union's capital structure for calculating a refund required under the ERI II earnings cap for ProvGas, then certain adjustments would be required.

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[78] Id., p. 4.
[79] Id., pp. 9-11.
[80] Id., pp. 11-12.

For instance, acquisition premiums associated with various regulated utilities that have been excluded from rate base must also be excluded from the calculation of capital structure.

Mr. Reed noted that Southern Union does have approximately $713.4 million of unamortized Goodwill on its balance sheets associated with its acquisition premiums for certain regulated utilities that are not recoverable through rates. Mr. Reed argued that this balance represents the cumulative, unamortized balance of acquisition premiums paid by Southern Union and, since acquisition premiums are excluded from rate base, then the capital used to finance these amounts should be adjusted out of the consolidated capital structure as well. Mr. Reed noted that these acquisition premiums, funded primarily through debt, were used by Southern Union to acquire NEGas, Pennsylvania Energy, and Missouri Gas and Electric. Furthermore, Mr. Reed indicated that a reduction of $114 million to the common equity account of Southern Union for the unamortized "Goodwill", and a $570 million reduction to the long-term debt account of Southern Union, would result in a capital structure of approximately 53% debt and 47% equity.

Mr. Reed argued that there is an established regulatory policy that supports restating a utility's capital structure to exclude capital associated with investments for which no rate recovery has been

allowed. Thus, a capital expenditure not included in rate base should also be excluded from the capital accounts use for ratemaking.[81]

Mr. Reed reiterated that it would not be appropriate to use Southern Union's capital structure to calculate ProvGas' ROE subject to the earnings cap. He stated that the ERI II Settlement provides for a default 50/50 debt/equity capital structure, which was triggered by the merger with Southern Union, because ProvGas' capital structure became nearly 100% equity after the merger. Also, Mr. Reed stated that the capital structure used to calculate ProvGas' ROE must be consistent with the capital structure used to set ProvGas' current rates. He argued that these rates reflect an imputed capital structure that is close to the 50/50 debt/equity default capital structure. Furthermore, Mr. Reed concurred with Division witness Matthew Kahal that it is inappropriate to use Southern Union's current capital structure because it is not representative of a typical LDC. Without an equivalent upward adjustment to its cost of capital, Mr. Reed stated that using Southern Union's capitalization would result in ProvGas rates that are not adequate to maintain sufficient credit quality and access to capital.[82]

Mr. Reed argued that ratemaking policies and principles would demonstrate that ProvGas' allowed return would be inadequate if it was based on Southern Union's highly leveraged capital structure. Mr. Reed

[81] Id., pp. 12-15.
[82] Id., pp. 15-17.

cited various cases in which ratemaking agencies have substituted a proxy capital structure for the actual capital structure of a utility.[83]

Citing S&P, Moody's and FitchRatings credit rating services, Mr. Reed described the various qualitative and quantitative factors in assessing creditworthiness and assigning credit ratings. He stated that three of S&P's financial measures are profitability, fixed charge coverage, and capitalization. Additionally, one of the guidelines used to assess "financial risk" is the generation of higher operating margins resulting in a greater ability to generate equity internally, attract capital externally, and withstand business adversity. Likewise, Fitch states: "Because industries differ significantly in their need for capital and capacity to support high debt levels, the assessment of leverage in the capital structure is based on industry norms." Mr. Reed stated that Southern Union's capitalization is outside of the bounds of such norms.

Mr. Reed stated that the ratio of debt to total capital is often considered to be a measure of financial safety and flexibility. The relationship between debt leverage and financial risk is also demonstrated in the S&P ratings criteria, and there is a direct relationship between risk and the return required by bondholders. Mr. Reed noted that financial leverage and its effect on pre-tax interest coverage and creditworthiness does affect utilities' ability to obtain reasonably priced long-term debt and equity. In addition, he stated that

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[83] Id., pp. 17-23.

leverage ratios that are out-of-line with industry norms tend to have a negative effect on common stock valuations and ultimately increase the cost of equity.[84]

According to Mr. Reed, selling assets to pay down debt and restructuring balance sheets by issuing equity is a trend that utilities with high debt leverage ratios use to improve creditworthiness. Mr. Reed noted that Southern Union announced a restructuring plan on January 7, 2003 by filing a registration statement with the Securities and Exchange Commission ("SEC") to issue up to $800 million of common equity, preferred equity and debt securities.[85]

In describing the implications of the pre-tax interest coverage ratios and debt to total capital ratios in the ERI II Settlement, Mr. Reed opined that a reasonable rate of return should produce a credit profile that enables the utility to attract adequate capital at reasonable rates. He stated that a pre-tax interest coverage ratio of 3.23 is produced by 50/50 equity/debt with an allowed ROE of 10.70%, which is consistent the natural gas utility industry average interest ratio of 3.21.

In general, Mr. Reed stated that debt leverage affects the cost of equity because the volatility of expected earnings increases when the debt leverage increases. As a consequence, he stated that the ROE increases with debt leverage. As an example, Mr. Reed endeavored to demonstrate the effect of debt leverage on earnings and equity risk in

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[84] Id., pp. 23-27.

the context of the ERI II Settlement by explaining the difference between a 50 percent debt leverage ratio and the debt leverage in Southern Union's capital structure. He stated that Southern Union's capital creates a wider range of possible earnings outcomes and, as a result, the volatility of equity returns is greater under the high debt leverage scenario. He argued that since the risk to shareholders increases as leverage increases, then the ROE should also increase. Thus, a ROE of 10.7% would be inadequate with the higher debt leverage scenario of Southern Union's capital structure.[86]

In conclusion, Mr. Reed stated that the use of a more highly leveraged capital structure creates the illogical result of requiring ProvGas to relinquish a substantial amount of earnings. Also, Mr. Reed emphasized that a dramatic change in ProvGas' capital structure without a very significant change in the costs of equity and debt would severely impair its financial condition, deny it access to capital on reasonable terms, and be inconsistent with numerous regulatory precedents and court decisions regarding fair rate of return and just and reasonable rates.[87]

XII. APRIL 7, 2003 HEARING

After notice, a public hearing was conducted on April 7, 2003 at the Commission's offices in Warwick, Rhode Island. At the request of

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[85] Id., pp. 27-30.
[86] Id., pp. 30-36.
[87] Id., pp. 36-37.

the Commission staff, Mr. Henry Shelton appeared on behalf of the George Wiley Center to answer questions regarding the ERI II Settlement to which his organization was a party.[88] Mr. Shelton indicated that he thought the Division or the utility had explained the meaning of Section I.3 entitled "Capital Structure" to him at the time of the ERI II Settlement. When asked to provide his interpretation and intent of Section I.3, he indicated that "when the new company came in they would assume all the responsibilities" as well as "all the agreements that were made before them".[89]

NEGas presented Mr. Kenneth Hogan as a witness. Mr. Hogan stated that he was involved in the ERI II Settlement negotiations and that ProvGas' intent was to use a 50 percent common equity capital structure.[90] Under cross-examination by Commission Counsel, Mr. Hogan indicated that Valley and ProvGas had an actual capital structure during the ERI II period. Also, he stated that NEGas had an actual capital structure during the ERI II period consisting of the actual capital structure of the pre-merger companies.[91]

Ms. Partridge concurred that in the NEGas merger rate filing of November 1, 2001, in response to Commission Rule 2.8 requiring presentation of the actual capital structure of the utility, NEGas referred

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[88] Although invited to attend, Mr. Roger Buck on behalf of TEC-RI did not appear at the hearing.
[89] Tr. 4/7/03, pp. 6-8.
[90] Id., pp. 17-19.
[91] Id., pp. 23-24.

to Mr. Dunn's pre-filed testimony. She acknowledged that Mr. Dunn's testimony never indicated that ProvGas or NEGas had an actual capital structure of 100 percent equity. After reviewing Mr. Dunn's pre-filed testimony stating: "As a division, New England Gas does not have its own capital structure", Ms. Partridge agreed with the statement "for ratemaking purposes…in Docket No. 3401."[92]

In regard to the ProvGas 2001 annual report, Ms. Partridge admitted that the report erroneously indicated that ProvGas controls Southern Union. In addition, she acknowledged that the annual report indicated that Southern Union does not own any percentage of stock in ProvGas. She also agreed that ProvGas has no capital stock according to the 2001 annual report.[93] The Commission took administrative notice that during the ERI II period Southern Union was the only corporation to provide gas utility service in Rhode Island and that during this time period ProvGas was registered as a "fictitious business name" at the office of the Rhode Island Secretary of State.[94]

Ms. Partridge stated that she has always maintained to this Commission that ProvGas was a division during the ERI II period, but acknowledged that in a settlement agreement between the Division and the New England Division of Southern Union signed on June 15, 2001,

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[92] Id., pp. 24-26.
[93] Id., pp. 27-29.
[94] Id., pp. 40-42, 51-52.

ProvGas was referred to as a "subsidiary".[95] Mr. Hogan indicated that he could not recall any specific language in the ERI II Settlement requiring ProvGas to maintain separate books of accounts for equity. Ms. Partridge acknowledged that prior to the merger, ProvGas had 42.3 percent common equity. Mr. Hogan indicated that the intent of the ERI II Settlement was to maintain the status quo with respect to earnings. When asked to explain how increasing the common equity ratios from 42 percent to 50 percent maintained the status quo, he said "I think it maintains the status quo".[96] Mr. Hogan agreed that when the ERI II Settlement was signed he assumed that the capital structure for ProvGas' earnings calculations would be 50 percent common equity. He also indicated that he assumed that in the post-merger capital structure of ProvGas there would be "no short-term debt". Furthermore, Mr. Hogan testified that the February 9, 2001 Deferred Gas Cost Settlement Agreement relating to the interest rate applied to deferred gas costs would not be applied if the 50 percent debt/50 percent equity capital structure was utilized by the Commission. When asked why ProvGas entered into the February 9, 2001 Deferred Gas Cost Settlement Agreement if it would have no effect on the 50/50 ProvGas' capital structure, Mr. Hogan stated "the best I could do is guess at this point", and indicated, "we weren't sure what was going to happen with

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[95] Id., pp. 47-49.
[96] Id., pp. 49-51, 53-55.

the capital."[97] On redirect examination, Mr. Hogan stated that Section C.2 of the Division-approved Merger Settlement required ProvGas to maintain separate books and accounts.[98]

NEGas also presented Mr. John Reed as a witness. Mr. Reed stated he had testified or filed testimony in approximately 150 cases, but had testified in only 15 to 20 cases regarding cost of capital or capital structure, and had listed only 5 to 6 cases in his resume that specifically listed cost of capital or capital structure.[99] Mr. Reed stated that he had not made any calculation regarding ProvGas' actual capital structure during the ERI I period, or regarding Southern Union's pre-merger capital structure. He was unaware if Narragansett Electric had remained a corporation after its merger. He testified that the ERI II Settlement and the Division-approved Merger Settlement did not address whether acquisition premiums are excluded from the capital structure. Also, Mr. Reed stated that he did not exclude non-utility operations from Southern Union's capital structure because it was a *de minimus* adjustment. Furthermore, Mr. Reed stated that the reduction in Southern Union's common equity ratio was not caused by this Commission but that management discretion was one factor in this reduction. Also, Mr. Reed agreed that the difference between the mean

[97] Id., pp. 59-63.
[98] Id., pp. 70-71.
[99] Id., pp. 77-78.

and median in earnings for a 50/50 capital structure and a 32% equity capital structure was only 1/100 of a percent.[100]

The Division presented Mr. Effron as a witness. At the outset, he admitted that, “as to what the appropriate capital structure would be for

> recent "pre-merger" actuals for the two companies. He provides no justification for such an increase."

After reviewing the testimony, Mr. Scialabba stated that "Mr. Kahal's statement here that Providence and Valley no longer exist as independent financial entities is true within the context of his answer."

Mr. Scialabba also reviewed Mr. Kahal's pre-filed testimony, which indicated that: "Mr. Dunn recommends a capital structure with a 49.3 percent common equity ratio which is a significant increase from the Providence/Valley pre-merger levels and levels previously approved by this Commission." After reviewing the statement, Mr. Scialabba indicated: "I agree that he said that within the context of establishing the rates on a going forward basis."[102]

Mr. Effron testified that he thought it was more likely than not that a 50/50 capital structure would be used in the ERI II Settlement. Mr. Scialabba acknowledged that he supervised the Division's cases in Docket Nos. 1673 and 1736 in 2000 and 2001, and was present at the January 23, 2001 hearing in those dockets. Mr. Scialabba reviewed the January 23, 2001 testimony of Mr. Bruce Oliver, the Division's witness, in Docket Nos. 1673 and 1736. With regard to the ERI II Settlement Agreement, Mr. Oliver testified that

> "the PSP calls for the ROE calculations under an ROE determination, under that agreement to be calculated based

[102] Id., pp. 94-99.

> on the company's actual capital structure. So if short-term debt is increased relative to other forms of capital, long-term debt and equity, as long as you reflect the actual cost of that short-term debt in calculations, the company's ROE calculation, the calculated ROE results should not be affected."

In response to a question relating to the capital structure under the ERI II Settlement, Mr. Oliver further testified that, "it's based on the actual capital structure, not one that was assumed at a point in time. So it will be based on the actual capital structure for the period being examined." After reviewing this testimony, when asked if he agreed with Mr. Oliver's testimony, Mr. Scialabba stated: "I can't say that I do" and could "not recall to what extent he worked on the financial areas" noting that "Mr. Effron was the chief expert or consultant on the accounting and the capital structure. I don't recall." He added: "I just don't recall Mr. Oliver's testimony. I'm reading it, and I didn't take note at the time that there was a difference between this and the ERI-2 Settlement."[103]

Mr. Scialabba also reviewed Mr. Oliver's January 23, 2001 testimony that stated "furthermore, the terms of the PSP extension that was approved back in September specifically reflect consideration of the company's actual capital structure as opposed to what has been the more traditional regulatory practices of setting rates based on an

assumed capital structure." Mr. Scialabba found it to be consistent with the ERI II Settlement. Also, Mr. Scialabba read Mr. Oliver's testimony that stated

> "when we entered into the ERI-2 settlement, there was no presumption that there was going to be additional gas costs that need to be financed as part of the capital structure that we were providing for at that time. Rather than restrict the company to a fixed allocation of its capital between short-term debt, long-term debt, and equity, we allowed that the determination of ROE would be based on actual capital structure so that there was flexibility in there to address these matters as they occurred."

Mr. Scialabba found Mr. Oliver's testimony to be consistent with a 50/50 capital structure interpretation of the ERI II Settlement.[104] The Commission then requested that the Division perform additional ERI II earnings calculations utilizing other capital structures, such as the Docket No. 3401 proxy capital structure and the last ProvGas pre-merger actual capital structure.[105]

Mr. Effron admitted that in developing the 50/50 capital structure in this proceeding he utilized information from Docket No. 3401. He utilized the long-term and short-term debt rates proposed by Mr. Kahal

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[103] Id., pp. 99-102. The PSP is the Price Stabilization Plan, which is another term for the ERI II Settlement Agreement.
[104] Id., pp. 106-107.

in Docket No. 3401. He also developed the short-term debt ratio by subtracting the 41.6 percent long-term debt, indicated by Ms. Partridge's testimony in Docket No. 3401, from 50 percent. Also, he did not know if the short-term debt rate of 4.86 percent he utilized was above Southern Union's actual short-term debt rate during the ERI II period.[106]

XIII. SUPPLEMENTAL POST-HEARING BRIEFS

A. NEGAS

On May 9, 2003, NEGas filed its supplemental post-hearing brief. NEGas indicated that the ERI II Settlement is a contract between the settling parties. NEGas stated that the settling parties do not disagree as to the interpretation of the capital structure provision in the ERI II Settlement. NEGas argued that it would be legal error to interpret the capital structure provision in a manner that varies from the interpretation of the parties. If the terms of the agreement are clear, then the words are given their plain, ordinary and usual meaning. Where there is no ambiguity, then the Commission is bound to accept the intent of the parties as to the meaning of the language. The language of an agreement is ambiguous if it is reasonably and clearly susceptible to more than one interpretation. If the language is not ambiguous then the Commission can not utilize extrinsic evidence. Also, NEGas argued that the Commission's interpretation of the ERI II

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[105] Id., pp. 110-113.
[106] Id., pp. 113-115.

Settlement would be a matter of law which would not be accorded deference by the courts.[107]

NEGas maintained that the intent of the settling parties was to use a 50/50 capital structure for ProvGas during the ERI II period. NEGas noted that pursuant to Section C.2 of the Division-approved Merger Settlement Agreement, ProvGas is required to maintain separate books of accounts. Also, NEGas noted that the Division Order approving the merger stated that ProvGas would become a division of Southern Union. In addition, NEGas stated that both parties testified that the 50/50 capital structure was the intent. Furthermore, NEGas emphasized that ProvGas had filed an annual report indicating it had virtually 100 percent common equity. [108]

NEGas argued that if ProvGas lacked an actual capital structure during the ERI II period, then the doctrine of impossibility would be applied and the party's performance would be excused. NEGas stated that ProvGas maintained its own books of account.[109] In addition, NEGas attempted to distinguish the Valley Gas case, decided by the Rhode Island Supreme Court in 1982, with the facts in this docket. NEGas stated that the prior Valley Gas case did not involve the interpretation of an agreement. Also, NEGas noted that in this proceeding, the parties have consistently argued for the use of a 50/50

[107] NEGas' Supplemental Post-Hearing Brief, pp. 6-10.
[108] Id., pp. 10-11.
[109] Id., pp. 12-14.

capital structure.[110] NEGas noted that in Docket No. 2286, ProvGas had an actual capital structure of 51.7% common equity. Also, NEGas stated that the percent of equity applicable to rate base during ERI I was in excess of 50 percent.

NEGas stated that any capital structure, other than the 50/50 capital structure, that includes short-term debt must be adjusted to remove balances associated with deferred gas costs in compliance with the Deferred Gas Cost Settlement Agreement. In addition, NEGas noted that the witnesses in Docket No. 3401 argued against the use of the Southern Union actual capital structure for ratemaking purposes. Specifically, NEGas argued that if the Southern Union's actual capital structure was used, capitalization relating to unregulated operations would have to be removed. Also, according to NEGas, acquisition premiums which are excluded from rate base would have to be removed from the capital structure. As of June 30, 2002, there was approximately $713 million in acquisition premiums of which 83% was funded with debt and 17% with equity. This results in a capital structure consisting of 47% equity and 53% debt.[111] Also, NEGas opposed the use of the proxy capital structure adopted in Docket No. 3401 because it is not an actual capital structure and would be retroactive ratemaking. Furthermore, NEGas opposed the use of the

[110] Id., pp. 14-18.
[111] Id., pp. 18-23.

pre-merger ProvGas capital structure because it included merger-related effects, such as no preferred stock and a high level of short-term debt.[112]

Lastly, NEGas stated that NEGas has a right to earn a fair rate of return and that the use of capital structure other than the 50/50 capital structure would constitute confiscation of property in violation of the 14th Amendment of the U.S. Constitution. Also, NEGas suggested that the use of another capital structure would be retroactive ratemaking.[113]

B. DIVISION

On May 9, 2003, the Division filed its supplemental post-hearing brief. In the area of unbilled revenue, Mr. Effron indicated the average balances of June 30, 2001 and September 30, 2001 should be set at $2,534,000. The Division noted that NEGas did not contest this adjustment. In the area of AFUDC, Mr. Effron indicated that AFUDC should be included in operating income. The Division noted that NEGas did not contest this adjustment. Lastly, the Division indicated support for the 50/50 capital structure interpretation.[114]

XIV. FINAL DATA RESPONSES AND NEGAS' SETTLEMENT OFFER

After supplemental post-hearing briefs, NEGas filed clarifications of certain data responses. On May 15, 2003, NEGas indicated that the average ProvGas deferred gas cost balance during the ERI II period was

[112] Id., pp. 23-25.
[113] Id., pp. 25-26.
[114] Division's Supplemental Post-Hearing Brief.

$15,589,244.[115] On May 19, 2003 NEGas indicated that the acquisition premiums totaled $687,707,000 during the ERI II period, which consisted of $114,847,000 funded through common equity and $572,860,000 funded through debt. Also, NEGas indicated that if: (1) all acquisition premiums are removed from the Southern Union capital structure, (2) the Southern Union capital ratios are applied to the ProvGas rate base, (3) the ProvGas deferred gas cost balance of $15,589,244 is removed from the capital structure, and (4) the Division's adjustments are utilized, there would be $5,885,000 in ProvGas over-earnings.[116] On May 21, 2003, NEGas indicated that if: (1) only acquisition premiums funded by common equity are removed from the Southern Union capital structure, (2) the Southern Union capital ratios are applied to the ProvGas rate base, (3) the ProvGas deferred gas cost balance of $15,589,244 is removed from the capital structure, and (4) the Division's adjustments are utilized, there would be $9,309,000 in ProvGas' over-earnings.[117]

On May 22, 2003, NEGas tendered a settlement offer to the Commission pursuant to Rule 1.24(b) to resolve the issues in this docket by agreeing to an ERI II over-earnings amount of $5,227,000 and to indicate an intent to withdraw its appeal to the Rhode Island Supreme Court of the Commission's May 1, 2003 order in Docket

[115] NEGas 4/7/03 Record Request 1-03.
[116] PUC Ex. 10: Schedules 12, 17, & 18.

3436.[118] On the same day, Mr. Thomas Ahern, Administrator of the Division, indicated the Division "does not object to the letter proposal" of NEGas. At the scheduled May 22, 2003 open meeting, the Commission accepted NEGas' settlement offer. On June 6, 2003, NEGas filed a compliance filing which was approved by the Commission at a June 30, 2003 open meeting. The compliance filing resulted in a net annual reduction of $19 or 1.6 percent to the average ProvGas residential heating customer, and an annual net reduction for all ProvGas customers of $948,589.

COMMISSION FINDINGS

I. LNG AND ERC

The LNG factor and the ERC factor are annual reconciliation components of DAC. The LNG factor reflects the system pressure. Due to a decrease in commodity charges relating to LNG, NEGas reduced the LNG factor in effect July 1, 2002 by .04 cents per therm. A rate reduction is in the public interest and therefore this factor is approved.

In addition, NEGas reduced the ERC factor by .02 cents per therm. The environmental response costs incurred through June 30, 2002 and incorporated into the factor have not been reviewed for prudence or reasonableness. Accordingly, the Commission approves the

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[117] Id., Schedules 23 & 24. NEGas' calculation was incorrect. The correct amount is $9,737,000.
[118] The amount of $5,227,000 was based on the use of the proxy capital structure in Docket No. 3401. A copy of the Settlement Offer is attached as Appendix A hereto and incorporated by reference herein. On July 30, 2003, NEGas withdrew its appeal of Order No. 17444.

decrease in the ERC factor as in the public interest but expressly reserves the right to review the prudence and reasonableness of these environmental response costs.

The most significant issue in this proceeding is the appropriate ERI II earnings calculations for ProvGas. NEGas indicated that it was entitled to an increase of $4,278,411 due to weather normalization from former ProvGas customers. This amount was originally $4,516,200 but was reduced by $237,789 due to non-firm margin sharing. Any earnings for ProvGas above 10.7 percent would be returned to former ProvGas ratepayers to offset the $4,278,411 increase sought by NEGas. NEGas argued that ProvGas had not earned above the authorized 10.7 percent during the ERI II period. This requires the Commission to review and interpret the ERI II Settlement Agreement to determine if NEGas' proposed earnings calculations for ProvGas during the ERI II period are accurate.

II. LEGAL FOUNDATION

Prior to interpreting the ERI II Settlement Agreement, the Commission must set forth the legal and regulatory framework with which it will utilize in this endeavor. The Rhode Island Public Utilities Commission is a quasi-judicial agency mandated to establish just and reasonable rates pursuant to Title 39 of Rhode Island General Laws. The Rhode Island Public Utilities Commission, like other public utility commissions, operates "pursuant to a broad statutory authorization

with a general mandate to establish just and reasonable rates without specific direction as to how that is to be accomplished."[119] Pursuant to R.I.G.L. Section 39-1-3, this Commission is a quasi-judicial body that engages in ratemaking of regulated public utilities in Rhode Island. The Commission's administrative proceedings constitute the quasi-judicial aspect of the ratemaking process, where the parties are heard and evidence is presented.[120] In contrast, the "rate setting process is often referred to as a legislative function, reflecting the fact that it was originally exercised by legislatures before being delegated to its PUCs".[121] The Rhode Island Supreme Court has concurred with this analysis by declaring that "the fixing of rates of a public utility is generally recognized as in essence a legislative" function.[122] Pursuant to R.I.G.L. Section 39-1-1, the General Assembly has delegated its ratemaking power to establish just and reasonable rates to this Commission.

The Commission can establish just and reasonable rates through a variety of approaches. One such approach is the settlement agreement process outlined in Commission Rule 1.24. Parties, such as the utility and the Division, can reach a settlement agreement through which just and reasonable rates are produced. Although the

[119] In Re: Public Service Co. of New Hampshire, 114 B.R. 820, 834 (Bkrtcy, D.N.H. 1990).
[120] Id.
[121] Id.
[122] New England Telephone v. Kennelly, 75 R.I. 422, 432 (1949).

Commission is not a party to the settlement agreement, it is an indispensable participant in the process because a settlement agreement can only go into effect if it is approved by the Commission. For instance, the ERI II Settlement Agreement was approved by this Commission and was incorporated in Order No. 16584. Since it is the Commission that establishes just and reasonable rates, the Commission has the obligation to interpret the settlement agreement and the order approving it.

Pursuant to R.I.G.L. Section 39-5-3, the Rhode Island Supreme Court accords deference to this Commission's orders on issues of fact, and will only disturb a Commission order if the Commission acted "illegally, arbitrarily, or unreasonably".[123] The Commission's interpretation of the order and settlement agreement must be based on law and evidence. This determination involves "mixed questions of law and fact".[124] The Rhode Island Supreme Court has noted that a "trial justice's findings on mixed questions of law and fact" is granted deference and, likewise, has stated that this Commission is entitled to

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[123] South County Gas Co. v. Burke, 551, A.2d. 22, 24 (R.I. 1988).

[124] Pascoag Fire District v. PUC, 636 A.2d 689, 691-692 (R.I. 1994). In this case, the Commission construed a statute requiring Division approval of the issuance of securities. The Commission determined whether a power contract entered into by Pascoag, a municipal electric utility corporation, had "any effect on Pascoag's capital structure". The Commission not only reviewed the statute, but reviewed "generally accepted accounting principles" and how the Commission had "historically" treated power contracts in relation to securities. Id. at 690-691.

the same deference required by R.I.G.L. Section 39-5-3 for "findings of the commission on mixed questions of law and fact".[125]

Similarly, a state utility commission in interpreting its order and an incorporated settlement agreement is accorded the same deference by the courts.[126] As noted by the Louisiana Supreme Court, "the deference accorded the Commission orders extends also to the Commission's interpretation of its own rules and past orders".[127] This approach is consistent with Rhode Island law. For instance, pursuant to R.I.G.L. Section 39-1-50, this "commission shall have jurisdiction over the interpretation of the terms and conditions of a securitization order". Likewise, the Rhode Island Supreme Court will defer to an administrative agency's interpretation of its own statutory authority when the agency is entrusted with the "administration and enforcement"

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[125] Id.

[126] Entergy Gulf States v. LPSC, 730 So. 890, 897 (La. 1999). In the Entergy case, the Louisiana Supreme Court reviewed and upheld, for most part, the Louisiana Public Service Commission interpretation of its prior order which incorporated a settlement relating to a merger. The Louisiana Public Service Commission interpreted its order and incorporated settlement agreement which related to such issues as rate base and capital structure for earnings calculations. The commission determined in the earnings sharing review of Entergy, subsequent to the merger, that ratepayers were entitled to a $9.635 million refund and a prospective base rate reduction of $33.275 million. The Louisiana Supreme Court upheld all but two of the commission's adjustments. Accordingly, ratepayers received a $5.992 million refund and a prospective base rate reduction of $27.159 million. Id. at 894.

[127] Id.

of the statute.[128] This "deference is accorded even when the agency's interpretation is not the only permissible interpretation."[129]

An order of this Commission establishing prospective rates has the "force and effect of a statute".[130] Thus, the rules of statutory construction have some applicability to interpreting an order of this Commission. First, it should be emphasized that statutory construction is a matter reserved for the courts.[131] Consequently, it is this Commission (subject to appellate review), and not the parties that appear before it, which has the authority to construe its orders and incorporated documents.

If a statute is clear and unambiguous, the task of interpretation is at an end and the court will apply the plain, ordinary and usual meaning of the words used.[132] In construing a statute, the court must attempt to apply the statute in a manner that will avoid rendering other provisions in the statute inconsistent.[133]

If the language of the statute is ambiguous, then other rules of statutory construction would be applied. This includes a review of the

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[128] Pawtucket Power Associates v. City of Pawtucket, 622 A.2d 452,456 (R.I. 1993). In Pawtucket Power, the Rhode Island Supreme Court determined that Pawtucket Power was subject to a tax exemption because the Commission had interpreted its statutes to determine that entities such as Pawtucket Power were not a utility under Title 39 of Rhode Island General Laws. Id.

[129] Id.

[130] New England Telephone v. PUC, 116 R.I. 356, 388 (1976).

[131] Brennan v. Kirby, 529 A.2d 633 (R.I. 1987).

[132] Bristol County Water v. PUC, 117 R.I. 89, 94 (1976).

[133] Id.

circumstances surrounding passage of the statute.[134] It also includes an examination of the legislative intent as reflected in primarily in legislative history and to a lesser extent the opinions of legislators.[135] Lastly, a court must construe a statute in a manner that will not lead to unreasonable results.[136]

In certain instances the rules of statutory construction parallels the rules of contract interpretation. In circumstances in which the Commission's order incorporates a settlement agreement, this Commission should take the added step of applying the law of contract construction to the incorporated settlement. Likewise, this Commission is entitled to the same deference in construing its order and incorporated settlement as a trial court would have in construing a contract.[137] Contract law principles are applicable to utility regulation. For instance, a New York court has indicated that a "tariff should be considered part of the contract between the customer and the utility with all ambiguities strictly construed against the drafter".[138] In addition, a state commission is entitled to deference in interpreting a tariff.[139]

The Commission must appropriately apply relevant aspects of contract law because a settlement is an agreement between the parties

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[134] Krikorian v. R.I. Dept. of Human Services, 606 A.2d 671 (R.I. 1992).
[135] State of R.I. v. Narragansett Tribe of Indians, 19 F. 3d 685 (D.R.I. 1993).
[136] Trembly v. City of Central Falls, 480 A.2d. 1359 (R.I. 1984).
[137] Security Bank and Trust v. Beaufort, 540 A.2d 13, 15 (R.I. 1988).
[138] Black Radio Network v. NYPSC, 685 N.Y.S. 2d 816, 818 (A.D. 3 Dept. 1999).
[139] Id.

in which the Commission is an indispensable participant who is charged with protecting the public interest. A settlement agreement is considered a binding contract under Rhode Island law.[140]

The rules of contract interpretation in Rhode Island are well-settled. In interpreting the language of a written contract, the first step is to determine if the language of the agreement is "clear and unambiguous".[141] If the language is clear and unambiguous then the contract terms "must then be applied as written", and contract construction ends.[142] If the language of the agreement is clear and unambiguous, "the actual terms" used are given their "plain, ordinary and usual meaning".[143] If the words are "technical terms" then a technical meaning is given to the words.[144] In addition, the contract as a whole must be reviewed so as to give an effective meaning to all terms of the agreement instead of an interpretation which leaves a part of the contract with no effect.[145]

The Rhode Island Supreme Court has also stated that "the intention of the parties must govern if that intention can be clearly inferred from its terms and can be fairly carried out with settled rules of law".[146] It is the objective intent of the parties as manifested in the plain words of the agreement that governs the interpretation of the agreement.

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[140] Homar Inc. v. North Farm Associates, 445 A.2d. 288, 290 (R.I. 1982).
[141] Vickers Antone v. Vickers, 610 A.2d 120, 123 (R.I. 1992).
[142] Id.
[143] Id.
[144] Contracts, 2nd Restatement, Section 202 (3)(b).
[145] Hill v. M.S. Alper & Sons, Inc., 106 R.I. 38, 47 (1969).

Furthermore, according to the Rhode Island Supreme Court, the intent of the parties "is not some undisclosed intent that may have existed in the minds of the contracting parties but the intent that is expressed by the language contained in the contract."[147] Rhode Island law is based on the objective theory of contract intent.[148]

If the wording is determined to be ambiguous, there are additional rules of contract construction. In the event the terms of the contract are deemed ambiguous, the meaning of words can be interpreted in a manner consistent with the subsequent course of performance, prior course of dealings and the trade usage.[149] In addition, the circumstances surrounding the execution of the contract are relevant in determining the meaning of the words.[150] Also, a court "will look" at the meaning placed on the words by the parties themselves "as an aid in determining their intended meaning".[151] In choosing among reasonable meanings, the ambiguity "must be construed against the drafter of the document".[152] Furthermore, if the agreement affects the public interest, in choosing among reasonable meanings, the meaning that favors the

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[146] Woonsocket Teachers Guild vs. Sch. Com., 117 R.I. 373, 376 (1976).
[147] Id.
[148] See John D. Calamari and Joseph M. Perillo, The Law of Contracts (3rd Ed. Hornbook Series, 1987), pp. 26-27.
[149] Contracts, 2nd Restatement, Section 202(5).
[150] Minor v. Narragansett Machine Co., 71 R.I. 108, 116 (1945).
[151] Woonsocket Teachers Guild v. Sch. Com., 117 R.I. 373, 376 (1976).
[152] Fryzel v. Domestic Credit Corp., 120 R.I. 92, 98 (1978). The rationale is that the drafter "may leave the meaning deliberately obscure, intending to decide at a later date what meaning to assert". Contracts, 2nd Restatement, Comment to Section 206.

public and/or the public interest is preferred.[153] Lastly, if it is determined that the parties to a contract failed to agree to a term which is essential to the contract, then the court may supply a term which is reasonable under the circumstances.[154]

In addition to utilizing contract law, the Commission will look to the law of business organizations for guidance in interpreting a settlement agreement in order to determine whether the intent of the parties is consistent with the law. This is necessary because utilities are business enterprises familiar with the terminology and requirements of Rhode Island law.

A corporation is a legal entity created under the authority of the laws of a state. Pursuant to R.I.G.L. Section 7-1.1-2, a domestic corporation is a corporation organized under the laws of this state, while a foreign corporation is organized under the laws of another state. Pursuant to R.I.G.L. Section 7-1.1.-7.1, a foreign corporation can transact business in this state under a "fictitious business name". Pursuant to R.I.G.L. Section 7-1.1-69(2), if one corporation merges with another corporation, the "separate existence of all corporations", that are parties to the merger "except the surviving…corporation ceases". Also, pursuant to R.I.G.L. Section 7-1.1-69(5), the surviving corporation "is subsequently responsible for all the liabilities and obligations of each

[153] Contract, 2nd Restatement, Section 207. It should be noted that this rule of contract construction rests "more on consideration of public policy than on probable intention of the parties." Comment of Section 207.

of the corporations merged" because the "surviving…corporation may be substituted" in the "place" of the pre-merger corporation. Furthermore, a corporation has a capital structure. This capital structure can consist of short and long-term debt, and preferred stock and common stock. [155]

In regards to the principles of public utility regulation, a "regulated corporation" has an "actual capital structure".[156] This capital structure consists of "the percentages of its capital that come from debt, common stock and preferred stock".[157] However, a "reasonable capital structure" can be "imputed" to a business entity such as a division of a corporation if the actual capital structure of the utility is inappropriate for ratemaking.[158] This latter capital structure is generally referred to as an imputed, proxy or hypothetical capital structure.[159]

The capital structure is a key component of establishing the rate of return of a utility for ratemaking. The rate of return is the weighted cost of capital for the utility. The weighted cost of capital is determined by multiplying each percentage component of the capital structure consisting of debt and stock by its applicable cost of capital rate and then taking the sum of each to arrive at the rate of return. The rate of

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[154] Contracts, 2nd Restatement, Section 204.
[155] Black's Law Dictionary (6th Ed., 1990), p. 210; Modern Dictionary for the Legal Profession (1993), p. 139.
[156] Communications Satellite Corp. v. FCC, 611 F.2d. 883, 904 (U.S. D.C. Cir. 1977).
[157] Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 301-302 (1988); Charles F. Phillips Jr., The Regulation of Public Utilities, (1993), pp. 388-391.
[158] See e.g. Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 301-302 (1988); Communications Satellite Corp. v. FCC, 611 F.2d. 883, 904-906 (U.S. D.C. Cir. 1977); Charles F. Phillips Jr., The Regulation of Public Utilities, (1993), pp. 388-391.
[159] Id.

return is then multiplied by the utility's rate base. This amount when added to operating expenses is the allowed revenue requirement of the utility for rate setting.[160]

When an administrative agency reviews evidence, Chairman James M. Landis noted that they are not limited to "the position of an umpire deciding the merits upon the record as established by the parties".[161] Chairman Landis emphasized that "it is imperative that controversies be decided as rightly as possible, independently of the formal record the parties themselves produced" because "to determine these matters purely upon the record as the parties made it, would lead to results governed more by chance than by the application of a consistent policy".[162]Consequently, administrative agencies have "the power of independent investigation".[163]

This principle of administrative law directly applies to rate making agencies. This Commission has clear statutory authority to adjudicate as well as to investigate.[164] This "combination of investigative and adjudicative functions does not … constitute a due process violation".[165]

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[160] The ratemaking process is expressed by the following formula: Capital Structure (CS) x Capital Costs (CC) = Rate of Return (RR). RR x Rate Base (RB) + Operating Expenses (O) = the Revenue Requirement (R). See In Re: Public Service Co. of New Hampshire 114 B.R. 820, 834 (Bkrtcy, D.N.H. 1990).

[161] James M. Landis, The Administrative Process, (1938), p. 36. Mr. Landis was a prominent New Deal regulator, who served as a FTC commissioner and Chairman of the SEC as well as architect of the legislation that created the SEC and the Public Utility Holding Act of 1935.

[162] Id. at 39-40.

[163] Id. at 36

[164] See e.g. R.I.G.L. 39-1-3, 39-1-20, and 39-3-11.

[165] Withrow v. Larkin, 421 U.S. 35, 58 (1975).

The power to investigate obviously means the ability to obtain and review evidence not offered by the parties in a proceeding.

When reviewing the evidence in any proceeding, including this proceeding to interpret the ERI II Settlement Agreement, the Commission can reject the expert opinion of witnesses presented to the Commission and utilize its own expertise or pick from among conflicting positions of the expert witnesses.[166] Justice Brennan once declared that a rate making agency like this Commission "is not intended to be passive arbiter but the guardian of the public interest", and consequently is "not a prisoner of the parties' submission" but must "make full use of the expert knowledge of commissioners and staff".[167] A rate making agency does not simply "act as umpire blandly calling balls and strikes for adversaries appearing before it", but instead has a duty to "see to it that the record is complete" and "consider all relevant facts".[168] The Rhode Island Supreme Court has determined that this Commission does not assume "the role of advocate" just because it rejects the positions of the parties before it and adopts a differing approach.[169]

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[166] See e.g. Wakefield Water Co. v. PUC 457 A.2d 251, 253 (R.I. 1983), Valley Gas Co. v. Burke, 446 A.2d 1024, 1033 (R.I. 1982); and R.I. Consumers Council v. Smith 111 R.I. 271, 295-296 (1973).

[167] Baltimore Ohio R. Co. v. United States, 386 U.S. 359, 427-430 (1967) (J. Brennan, concurring).

[168] Scenic Hudson Preservation Conference v. FPC, 354 F.2d. 608, 620 (U.S. 2nd Cir, 1965).

[169] Valley Gas Co. v. Burke, 446 A.2d 1024, 1033 (R.I. 1982). The sentiments expressed in the above paragraph were reiterated by Commissioner Racine and echoed by Commissioner Gaynor at the February 6, 2003 hearing. Tr. 2/6/03, pp. 131-136.

Based on these fundamental legal and regulatory principles, the Commission reviewed the ERI II Settlement Agreement, conducted fact-finding, and analyzed each of the potential interpretations of the ERI II Settlement Agreement, specifically Section I.3 relating to capital structure. During the process, the Commission remained cognizant of its legislative mandate to establish just and reasonable rates, serve the public interest, and protect the interest of the ratepayers.

III. INITIAL ADJUSTMENTS TO ERI II EARNINGS CALCULATIONS

NEGas' ERI II earnings calculations for ProvGas indicated that ProvGas had not earned above the authorized 10.7 percent ROE. The Division differed with NEGas on this issue. The Commission will now review each of the Division's proposed adjustment to NEGas' proposed earnings calculations for ProvGas during the ERI II period.

A. IRP ADJUSTMENT

Section F of the ERI II Settlement entitled "Low Income and Demand Side Management Commitments" stated that:

> 1. The Low Income Assistance Program will be funded at an annual level of $1.3 million for each year of the Extended Term.
> 2. The Demand Side Management rebate program will be funded at an annual level of $0.3 million. The Company agrees to work with the Settling Parties on simplifying the administrative requirements of the current program.
> 3. The Low Income Weatherization Program will be funded at an annual level of $0.3 million for the first year and $0.2 million for the second year.

In response, counsel for NEGas stated as follows "I've listened to the statements of Commissioner Racine and Commissioner Gaynor, I don't disagree with most of the points that you made". Id. at 137.

NEGas has charged $2,212,000 for IRP programs to revenues. In contrast, the Division has limited the charge to $1.85 million. The Division's interpretation is appropriate.

The clear and unambiguous language of Section F allows for $1.9 million in IRP funding during the first year and $1.8 million of funding during the second year. The Division's use of $1.85 million, which is the average of these two years, is appropriate and simplifies the earnings calculations. NEGas' additional charge of $250,000 to ProvGas LIHEAP customers is certainly in error. First, the language of Section F clearly limits the amount of IRP funds that can be charged to revenues. Also, in a prior Commission order, the Commission clearly indicated that the $250,000 contribution to LIHEAP was to come from shareholders' earnings.[170] As for the additional $112,000 charged by NEGas, this is a simple mathematical error because NEGas double-counted Low Income Assistance Program costs for the three months that overlap the two twelve-month periods used for ERI II earnings calculations. The Commission adopts the Division's interpretation as to IRP funding.

B. ENVIRONMENTAL RESPONSE COSTS

Section G of the ERI II Settlement is entitled "Environmental Response Fund." Subsection G(1)(b) is entitled "Funding" and it provides:

[170] Order No. 16745, pp. 22, 58, 71-72, 82.

> Interest shall accrue for the benefit of customers, on any credit balances in the fund at the customer deposit rate. No interest shall accrue on debit balances.

NEGas argues that environmental response costs are included in rate base and therefore, ProvGas is entitled to a rate of return on these costs. In contrast, the Division indicates that environmental response costs are not included in rate base and therefore, ProvGas is not entitled to any interest or return on these costs. The Division's interpretation is correct.

The clear and unambiguous language of Subsection G(1)(b) states that "no interest shall accrue" to shareholders for environmental response costs while "interest shall accrue for the benefit of customers, on any credit balances". The word "interest" can be defined as "the compensation allowed…for the use…of borrowed money."[171] A rate of return can be defined as a "return on an investment". [172] To include environmental response costs in rate base would allow shareholders to obtain a rate of return on these costs. A rate of return is the equivalent of the cost of capital. This cost of capital not only includes interest on debt, but also a return on equity. To include environmental response costs in the rate base would be even more profitable to the shareholders than charging a mere carrying cost on environmental response costs. Therefore, inclusion of environmental response costs in rate base with a

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[171] Black's Law Dictionary (6th Ed., 1990), p. 812
[172] Id., p. 1261,

corresponding rate of return is clearly contrary to the meaning and intent of the words “no interest”.

Alternatively, if Subsection G(1)(b) was deemed ambiguous, the Commission would apply other rules of construction. Regarding prior dealings of the parties, NEGas noted that environmental response costs were included in the rate base under the ERI I Settlement. However, the Narragansett Electric Merger Rate Settlement contains the exact same language as the ERI II Settlement indicating “no interest shall accrue on debit balances” for environmental response costs.[173] There is no dispute that the Narragansett Electric Merger Rate Settlement does not include environmental response costs in the rate base. More interestingly, in the transmittal letter accompanying the ERI II Settlement filed with the Commission, counsel for ProvGas indicated the accounting treatment for environmental response costs “is designed to be consistent with the Commission’s treatment of similar expenditures in the electric industry.”[174] It is clear that the language from the recent Narragansett Electric Merger Rate Settlement was inserted into the ERI II Settlement so as to exclude environmental response costs from ProvGas’ rate base.

NEGas argues that at the September 22, 2000 hearing at which the ERI II Settlement was reviewed by the Commission, Mr. Hogan, a ProvGas witness, indicated that environmental response costs were

[173] Two of the four parties to the Narragansett Electric Merger Settlement Agreement, the Division and TEC-RI, were also parties to the ERI II Settlement.
[174] ProvGas’ transmittal letter of 8/2/00 p. 4.

included in the rate base and that the Commission referenced this testimony in its order. However, the Division noted that the cross-examination on the issue was ambiguous and that Mr. Hogan used the past tense when he discussed the inclusion of environmental costs in the rate base. In regards to the Commission's order, Mr. Hogan's testimony was discussed in the travel of the proceeding but it was not referenced in the Commission's findings.

Moreover, after the September 22, 2000 hearing and the issuance of the Commission's order, NEGas' subsequent course of performance indicated that it considered environmental response costs as excluded from the rate base. In its initial filing in this proceeding, NEGas excluded environmental response costs from the rate base for ProvGas earnings calculations for the ERI II period. It was only on October 21, 2002, just one day prior to the hearing, that NEGas made a corrected filing indicating for the first time that environmental response costs are included in the rate base. This last minute change of position did not go unnoticed by the Commission. The Commission adopts the Division's interpretation of Subsection G(1)(b).

C. STATUTORY TAX RATE AND PREPAYMENTS

The ERI II Settlement does not clearly indicate which federal income tax rate to use for earnings calculations or whether the prepayment expenses are to be included in rate base. NEGas argues

that the ambiguities should be construed in its favor. In contrast, the Division noted that in Section I.2, reference is made to "Commission ratemaking principles" in regards to earnings calculations. Also, the Division argued that it is consistent with Commission ratemaking principles to use the statutory federal income tax rate and to exclude prepayments from rate base.

To resolve these issues, the Commission examined the prior dealings of the parties. In regards to the use of the statutory tax rate or the actual (or effective) tax rate, the Commission notes that in Docket No. 2286 and in the ERI I Settlement, the statutory tax rate of 35 percent was utilized. Furthermore, it appears from a cursory review of recent Commission cases that the trade usage in Rhode Island is that the Commission has used the statutory tax rate in its rate proceedings. In regards to the exclusion of prepayments from rate base, it appears that in the prior dealings of the parties in Docket No. 2286 and in the ERI I Settlement, prepayments were excluded from the rate base. There is no apparent reason to interpret the ERI II Settlement so as to depart from prior Commission ratemaking principles as applied to ProvGas.

Furthermore, an ambiguity will be construed against the drafter of the contract. The ERI II Settlement was apparently drafted by the utility. Therefore, a reasonable meaning unfavorable to the utility should be utilized. Furthermore, the ERI II Settlement is an agreement affecting the public interest and, therefore, should be construed in favor

of the public interest. The Division's interpretation in this instance is more favorable to the public and is in the public interest, and consequently, will be adopted.[175]

D. 1.75 MULTIPLIER

The Division's use of the 1.75 multiplier to calculate ProvGas' earnings for the 21-month ERI II period is not expressly set forth in the ERI II Settlement. However, it is reasonable to use a 1.75 multiplier to gross up 12 months to 21 months. The 1.75 multiplier is implied in terms of the ERI II Settlement and is mathematically accurate. Moreover, NEGas acknowledged that if the 1.75 multiplier is not utilized, NEGas will be able to retain earnings above the 10.7 percent authorized ROE. Consequently, the Division's use of a 1.75 multiplier to calculate ProvGas' ERI II earnings is appropriate.

E. UNCONTESTED MATTERS AND INTEREST RATE

The Division made two additional adjustments to the ERI II earnings calculations. First, the Division adjusted the unbilled revenue amounts of ProvGas during the ERI II period. Second, the Division included AFUDC in operating income because plant under construction was included in the rate base. NEGas did not contest either adjustment. These adjustments are not inconsistent with the express provisions of the ERI II Settlement or Commission ratemaking

[175] This discussion relating to the rules of construing against drafter and construing in favor of the public/public interest can also be applied to any provision of the ERI II

principles. Also, both adjustments further increase the amount of earnings to be returned to ratepayers. Consequently, the Commission finds the Division's adjustments to be reasonable.

As for the Division's interest rate adjustment, this adjustment reflects the inclusion of short-term debt in a capital structure consisting of 50% common equity and 50% debt. NEGas opposes this adjustment and argues for the 50% debt to be considered solely as long-term debt. At this juncture, the Commission determined it needed to examine the capital structure provisions of the ERI II Settlement.

IV. CAPITAL STRUCTURE

In calculating the earnings of ProvGas during the ERI II period, it is necessary to utilize the correct capital structure in effect for the ERI II time period. Under the ERI II Settlement, the correct capital structure is set forth in Section I.3 entitled "Capital Structure". This section states:

> The Company shall use the actual capital structure and associated costs of capital in determining its earned return on equity, as described in Paragraph 1. However, the Company's actual level of equity and total capital for financial accounting purposes will be affected by the pending merger with Southern Union. Therefore, if ProvGas' actual average common equity ratio is above 50% for any reporting period during the Extended Term, then the Company shall use a capital structure consisting of 50% debt and 50% equity.

The Commission must now interpret the meaning of Section I.3 to determine the amount, if any, of ProvGas' earnings above the authorized

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Settlement Agreement determined to be ambiguous in Section III of the Commission's findings.

10.7 percent ROE, which is to be returned to the ratepayers. The Commission notes that there was no discussion or explanation given to this section either during the proceedings examining the reasonableness of the ERI II Settlement, or in the resulting order. A review of the exhibits ae0.enscripitsrelalting(to(theap prval (of the ERI)-10.2(I)-10.2(I)-10.2( )10 Settle

A. THE 50% DEBT EQUITY/50% EQUITY CAPITAL STRUCTURE

NEGas argued for the interpretation of 50 percent debt/50 percent equity capital structure. NEGas argued that ProvGas had an "actual capital structure" of nearly 100 percent common equity during the ERI II time period. According to NEGas, ProvGas' "actual average common equity ratio" was above 50 percent during the ERI II period and therefore, a 50 percent debt/50 percent equity structure is required under the third sentence of Section I.3 of the ERI II Settlement. Also, NEGas interpreted 50 percent equity in the third sentence to be 50 percent common equity.

Counsel for NEGas argued that the language of the ERI II Settlement was "clear".[177] He also indicated that the Commission, when interpreting a settlement, must "look at the terms of the settlement based on the clear language of the settlement and what the intent of the parties were to the settlement".[178] Accordingly, the Commission will apply Rhode Island contract law, and will first determine whether the language in the ERI II Settlement regarding capital structure is clear and unambiguous. At the outset, the Commission notes that the objective theory of contract intent means that the intention of the parties as clearly manifested in the terms of the agreement. Intent does

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[177] Tr. 2/6/03, p. 83.
[178] Id., pp. 84-85.

not mean an "undisclosed" meaning "not expressed in the agreement".[179]

1. Clear and Unambiguous Approach

a. Plain, Ordinary and Usual Meaning

Assuming the phrase "actual capital structure" is clear and unambiguous, the Commission must determine its meaning. In interpreting the language of the agreement, the words are to be assigned their plain, ordinary and usual meaning. The word "actual" means "existing presently in fact, having a valid objective existence" as opposed to "theoretical, hypothetical" or "fictitious".[180] Fictitious is the antonym of actual.[181]

The phrase "capital structure" means the "composition of a corporation's equities; the relative proportions of short-term debt, long-term debt, and owners' equity", or in other words the "financing of a corporation which is represented by long-term debt, preferred stock, common stock".[182]

The ordinary meaning of the phrase "actual capital structure" can not mean ProvGas after the merger. ProvGas ceased to exist as a corporation on September 28, 2000, prior to the beginning of the ERI II period, when it merged with Southern Union, a Delaware corporation.

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[179] Woonsocket Teachers Guild v. Sch. Com., 117 R.I. 373, 376 (1976).
[180] See definition of "actual" in Black's Law Dictionary, 6th Ed., p. 34, and West's Legal Thesaurus/Dictionary, p. 21.
[181] Random House Webster's Unabridged Dictionary (2nd Ed. 1998), p.21.
[182] See definition of "capital structure" in Black's Law Dictionary, 6th Ed., p. 210, and Modern Dictionary for the Legal Profession, p. 139.

ProvGas was a division of Southern Union or a component of NEGas, a division of Southern Union during the ERI II period. ProvGas was merely a "fictitious business name" under R.I.G.L. Section 7-1.1-2 during the ERI II period.[183] ProvGas ceased having common stock on September 28, 2000, and had none during the ERI II period. Also, during the ERI II period ProvGas had all its debt financing, short-term and long-term debt, assumed by Southern Union.[184]

NEGas' argument for construing ProvGas as having an "actual capital structure" would require this Commission to adopt an interpretation mandating that a fictitious business name, ProvGas, had an actual capital structure. This is clearly contrary to the plain, ordinary, and usual meaning of "actual capital structure".

b. Technical Meaning

The phrase "actual capital structure" is a technical term primarily utilized in public utilities regulation. Therefore, the Commission will examine how the term is utilized throughout the nation. It is clear from an examination of approximately 59 court cases, including the decisions

[183] Documentation of the R.I. Secretary of State.

[184] Tr. 5/6/02, pp. 63- 64. When asked a question regarding "the most recent level of equity for Providence Gas as a stand-alone company", Mr. Kahal stated "by most recent I think we mean most recent premerger, because it loses its meaning after the merger takes place". Also, Ms. Partridge indicated that "the independent companies no longer have their own outstanding debt. Everything is held by the corporation". In an answer to a question regarding the use of "the actuals of the merged companies in New England, i.e., Valley and Providence", Mr. Kahal answered that "Southern Union Company will serve as the source of capital for New England Gas Company operations in the future. New England Gas Company is not going to go out and issue its own debt or its own common stock". Id. at 60-61. Ms. Partridge admitted in reference to ProvGas during the ERI II period that "we don't have stock on our own". Tr. 2/6/03,

of the U.S. Supreme Court, U.S. Circuit Court of Appeals for the District of Columbia, and state court decisions from 22 states, that the term "actual capital structure" is uniformly used in reference to a corporation and not to a division of a corporation for rate making purposes.[185]

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pp. 122-123. She reiterated this statement by stating that "there's no common stock" for ProvGas after the merger. Tr. 4/7/03, pp.28-29.

[185] Schneidewind v. ANR Pipeline Co., 485 U.S. 293, 301-302 (1988); North Carolina Utils. Com. v. FERC, 42 F.3d 659, (U.S. App.D.C. 1994); Public Service Com. v. FERC, 813 F.2d 448, (U.S. App. D.C. 1987); Charlottesville v. FERC

These courts utilize the phrase "actual capital structure" either in reference to a parent corporation or a subsidiary corporation.

There are a few cases that are particularly informative. For instance, the New Mexico Supreme Court declared that "PNMGS, a division of PNM has neither debt and equity in its own name upon which to base the cost of capital nor an actual capital structure of its own".[186] The New Mexico Supreme Court stated three other times in its decision that PNMGS, a gas utility division of PNM, has "no actual capital structure".[187] In fact, the New Mexico Supreme Court reversed, in part, the New Mexico Public Utility Commission because the state commission had required PNMGS to provide "additional calculations based on its actual capital structure", when, as noted by the New Mexico Supreme Court, "in fact, PNMGS has no actual capital structure of its own".[188] It is clear from this New Mexico case, that it would be reversible error to conclude that a division of a corporation has its own actual capital structure.

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v. Oklahoma Corp. Com., 769 P.2d 1309, (Okla. 1988); Penn Sheraton Hotel v. Pennsylvania PUC, 184 A.2d 324, (Pa. Super. 1958); Pittsburgh v. Pennsylvania PUC, 128 A.2d 372, (Pa. Super. 1956); T.W. Phillips Gas & Oil Co. v. Pennsylvania PUC, 474 A.2d 355, (Pa. Comm. 1984); Carnegie Nat'l Gas Co. v. Pennsylvania PUC., 433 A.2d 938, (Pa. Comm. 1981); Blue Mountain Consol. Water Co. v. Pennsylvania PUC, 426 A.2d 1118, (Pa. Comm. 1981); Railroad Com. of Texas v. Entex, Inc., 599 S.W.2d 292, (Tex. 1980); Terra Utils. v. Public Serv. Com., 575 P.2d 1029, (Utah 1978); Central Tel. Co. v. State Corp. Com., 252 S.E. 2d 575, (Va. 1979).

[186] In Re: Petition of PNM Gas Services, 1 P.3d 383, 393 (N.M 2000). PNMGS is an abbreviation for PNM Gas Services while PNM is an abbreviation for Public Service Company of New Mexico. Id. at 389.

[187] Id. at 395-396.

[188] Id. at 394-395.

In addition, the Colorado Supreme Court has declared that "Peoples Division operates as a gas distribution utility in Colorado" but "has no independent capital structure or corporate existence" and "its capital requirements are provided entirely by Northern."[189] The Colorado Supreme Court's reasoning indicates that an actual capital structure is synonymous with a corporate existence by stating that "Peoples Division does not have an independent corporate capital structure"[190]. This approach was echoed by the Minnesota Court of Appeals when it declared that "Peoples, which is a division of UtiliCorp and receives all of its capital, both debt and equity, from UtiliCorp, does not have a capital structure of its own".[191] A review of the Colorado and Minnesota court cases indicate that in public utility ratemaking, an independent actual capital structure requires an independent corporate existence.

Although the Rhode Island Supreme Court has never used the phrase "actual capital structure", it has used the phrase "capital structure" in a dozen cases reviewing this Commission's decisions. In each of those occasions, the Rhode Island Supreme Court was referring to a corporation.[192]

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[189] Peoples Natural Gas, v. PUC, 567 P.2d. 377, 379 (Col. 1977).
[190] Id. at 380.
[191] Application of People Natural Gas Co., 413 N.W.2d. 607, 612 (Minn. App. 1987). In 1985, Northern Natural Gas Company sold its Peoples Natural Gas Division to UtiliCorp. Id. at 609.
[192] Pascoag F.D. v. PUC, 636 A.2d 689, (1994); Town of New Shoreham v. Burke, 519 A.2d 1127, (1987); Wakefield Water v. Burke, 502 A.2d 816, (1986); Narragansett Electric v. Burke, 475 A.2d 1379, (1984); Burke v. New England Telephone &

The technical term "actual capital structure" in the public utility regulation clearly requires the existence of a corporation. ProvGas was not a corporation during the ERI II period, and had no common stock. Therefore, neither the plain, ordinary, and usual meaning or the technical meaning of the phrase "actual capital structure" can apply to ProvGas following the merger.

c. Consistent with Other Provisions of the ERI II Settlement

The next step in the analysis is to determine whether the interpretation that ProvGas has an "actual capital structure" is consistent with other provisions of the ERI II Settlement. NEGas' position is that the intent behind Section I.3 was that, following the merger, ProvGas' would have an "actual capital structure" of 100% common equity and therefore a 50/50 debt to equity proxy capital structure would be applied. This interpretation does not coincide with the appropriate order of sentences in Section I.3. NEGas' argues that the primary intent of Section I.3 is to use a 50/50 capital structure. If this were the case, the section should have been written with the 50/50 proxy capital structure provision in the first sentence of the paragraph instead of indicating that "the actual capital structure", would be used. As currently written, Section I.3 indicates the intent is to use "the actual

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Telegraph Co., 121 R.I. 659, (1979); Bristol County Water Co. v. Harsch, 120 R.I. 223, (1978); Narragansett Electric Co. v. Burke, 119 R.I. 559, (1977); Providence Gas Co. v. Burman, 119 R.I. 78, (1977); New England Telephone & Telegraph Co. v. PUC, 118 R.I. 570, (1977); Narragansett Electric Co. v. Harsch, 117 R.I. 395, (1977); R.I. Consumers' Council v. Smith, 113 R.I. 384, (1974); R.I. Consumers' Council v. Smith, 111 R.I. 271, (1973).

capital structure" while the 50/50 proxy capital structure appears as a secondary contingency concept.

Mr. Effron argued on behalf of the Division that any business unit or entity has equity. He is correct; however, only a corporation has "actual common equity" because only a corporation can have common stock. The third sentence of Section I.3 is only triggered if the "actual common equity ratio" of ProvGas is above 50 percent. Actual common equity is synonymous with actual common stock. At a hearing, Mr. Effron had testified that "common stock might be used … interchangeably with common equity."[193] A child involved in Junior Achievement of Rhode Island can save up her allowance to pay for a lemonade stand. Her payment would be equity, but it would not be "actual common equity" unless she set up a corporation with common stock. Furthermore, this clever child could create a balance sheet for her lemonade business which indicates it has 100% equity in the lines reserved for "common stock" and "capital stock". However, her balance sheet would not be sufficient to prove she owns common stock or that her business consists of 100% actual common equity.

More striking is the interplay between a ProvGas interpretation and Section I.2 which is entitled "Calculation of Return on Equity." NEGas maintains that the intent was that following the merger ProvGas would have an actual capital structure of 100% common equity and

[193] Tr. 2/6/03, pp. 123-124.

therefore a 50/50 proxy capital structure. The second paragraph of Section I.2 states:

> The return on common equity will be calculated by dividing the net income available for common equity by the common equity applicable to rate base…less applicable interest and preferred dividends (if any)…The applicable interest shall be calculated by multiplying average rate base by the percentage debt in the capital structure…times the applicable cost rate, and the applicable preferred dividends, if any, shall be calculated by multiplying average rate base by the percentage of preferred stock in the capital structure times the applicable cost rate. The common equity applicable to rate base shall be calculated by multiplying the actual common equity ratio…by rate base.

If ProvGas intended to have an actual capital structure with 100% actual common equity, then a 50/50 proxy capital structure would be the result. If a proxy capital structure of 50/50 debt to equity ratio, with the equity being construed as 50% common equity, was the primary intent of the ERI II Settlement, then the language in Section I.2 referring to "preferred dividends (if any)" is incomprehensible and unnecessary. There would have been no reason to even consider including language for "preferred dividends" or "preferred stock" unless an actual capital structure was contemplated. It is interesting to note that Section I.2 clearly envisions the use of an "actual capital structure" and not a 50/50 proxy capital structure. For instance, the phrase "preferred stock" instead of preferred equity is utilized. Also, the phrase "actual common equity ratio" is utilized instead of "proxy common equity ratio." The drafter of Section I.2 certainly envisioned the use of an actual capital structure, including a capital structure possibly with

"preferred stock", and did not appear to anticipate the near certainty that a 50/50 proxy capital structure would be utilized as NEGas contends.

The use of the phrase "common equity applicable to rate base" provides further evidence that the phrase "the actual capital structure" was not intended to mean ProvGas. Since acquisition premiums are excluded from rate base under the Division Merger Settlement, this phrase was intended to exclude any common equity in the capital structure used to pay for acquisition premiums from ProvGas' earning calculations. Southern Union was paying acquisition premiums to obtain ProvGas. ProvGas was not paying acquisition premiums to purchase Southern Union.

Section I.2's repeated reference to "common equity applicable to rate base" does not make any logical sense if the assumption of Section I.3 was to use a 50/50 proxy capital structure.[194] The need to exclude acquisition premiums in the common equity portion of the actual capital structure would be irrelevant and unnecessary if there is a 50/50 proxy capital structure. It also does not make sense even if ProvGas, although a division, had 100% actual common equity. NEGas has indicated that ProvGas' 100% common equity is due to the assumption of all debt by Southern Union. In other words, there appears to be no acquisition premiums in ProvGas' 100% actual common equity as described by

NEGas. The drafter of Section I.2 appears to envision a capital structure that contained acquisition premiums. This suggests that a ProvGas interpretation is inappropriate.

It is apparent that the drafter of the ERI II Settlement did not consider the 50/50 proxy capital structure as likely. Section I. 2 uses terminology only appropriate for an actual capital structure and for a capital structure containing acquisition premiums. Also, the reference to 50% debt/50% equity is vague. It does not specify the percentage of short-term, long-term debt, preferred equity or common equity. NEGas simply interprets 50% equity to mean only common equity.[195] The ERI II Settlement is also silent as to a specific number for the cost rate for long-term debt. Accordingly, the Commission finds that the language of the ERI II Settlement does not clearly provide for the use of a 50/50 capital structure.

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[194] This provision relating to "common equity applicable to rate base" also limits the capitalization used to calculate earnings so as not to exceed the rate base.

[195] The Division also interpreted 50% equity to mean 50% common equity. Interestingly, the Division interpreted 50% debt to include short-term debt as well as long-term debt. The Division determined the percentage of short-term debt for this proxy capital structure by subtracting the amount of long-term debt held by ProvGas immediately before the merger from 50%. ProvGas had 41.6 percent long-term debt and therefore, Mr. Effron calculated that the short-term debt should be 8.4 percent. However, when addressing equity, the Division did not distinguish between different kinds of equity: common and preferred. It determined there was no preferred equity in the proxy capital structure. It could have done so by reducing the common equity level that existed prior to the merger from 50%. This would have resulted in a common equity level of 42.3 percent, and a preferred equity level of 7.7 percent.

2. Ambiguous Approach

a. Subsequent Performance, Course of Dealing, and Trade Usage

(i) Trade Usage

Assuming the phrase "actual capital structure" is ambiguous, other rules of contract construction must be utilized. First, the phrase "actual capital structure" must be reviewed in light of subsequent course of performance, prior course of dealing and trade usage. An analysis of the trade usage for the phrase "actual capital structure" is similar to an analysis of the technical meaning. In the trade usage of Rhode Island public utility regulation, the phrase "actual capital structure" has appeared in approximately 25 Rhode Island Public Utilities Commission orders over nearly three decades involving numerous utilities, including ProvGas.[196] In each of these instances, this Commission has only used the phrase "actual capital structure" in reference to an actual corporation. In addition, the two other major

[196] Order 17381 New England Gas Company's Rate Consolidation Filing; Order 16200 Narragansett, BE & Newport Electric: Adjustment of Rates; Order 14859; Providence Gas Company: Rate Case; Order 14957 Narragansett Electric Company: Tariff Filing, Rate Case Decision; Order 14039 Newport Electric Corp.: $3,660,000 Additional Revenue; Order 13899 Narragansett Electric: Report and Order Rejecting Tariff; Order 13877 Blackstone Valley: Rate Schedules Changes; Order 13534 Prov. Gas Co.: Tariff Filing; Order 13270 Narr. Electric Co.: Rate Filing; Order 12974 Prov. Gas Co.: Tariff Filing; Order 12293 South County Gas Company: Rate Filing; Order 11862 Bristol County Water: February 12, 1985 Tariff Filing; Order 11685 New England Telephone: September 19, 1984 Tariff; Order 11436 Providence Gas Company: Rate Filing; Order 11041 NE Telephone Company: Rate Filing; Order 10950 South County Gas Company: Rate Filing; Order 10857 Bristol County Water Company: Rate Filing; Order 10850 Valley Gas Company: Rate Filing; Order 10520 Bristol & Warren Gas Company: Rate Filing; Order 10513 NE Telephone Company: Rate Filing; Order 10372 Newport Electric Corporation: Rate Filing; Order 10343 Valley Gas Company: Rate Filing; Order 10186 Bristol & Warren Gas Company: Rate Filing; Order 9515 Narragansett Electric

investor owned utilities in Rhode Island, Verizon and Narragansett Electric, use the phrase "actual capital structure" in reference to a corporation.[197] Thus, the trade usage of "actual capital structure" in Rhode Island public utility regulation has the same connotation as the technical meaning of "actual capital structure" in national public utility regulation.

(ii) Prior Course of Dealing

As for the prior course of dealing, ProvGas has used the phrase "actual capital structure" in reference to itself because it existed as a corporate subsidiary of Providence Energy. The phrase "actual capital structure" appears in ProvGas' last fully litigated rate case in Docket No. 2286.[198] In the ERI I Settlement, which included all of the settling parties to the ERI II Settlement, the parties used an actual capital structure for earnings calculations.[199] In both instances, the phrase applied to a corporation, namely ProvGas.

However, in the Merger Settlement between ProvGas, the Division and TEC-RI, which was approved by the Division, the phrase "actual…capital structure" is only used for Southern Union, the

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Company: Rate Filing; Order 9500 Bristol & Warren Gas Company: Rate Filing; Order 9122 BV Electric Company: Rate Filing.

[197] The phrase "actual capital structure" in the Narragansett Electric Merger Rate Settlement is applied to Narragansett Electric, a subsidiary. The use of an "actual capital structure" in Verizon-Rhode Island's earning report filed on April 15, 2003 applies to Verizon-New England, a subsidiary. It does not apply to Verizon-Rhode Island which is a fictitious business name.

[198] Order No. 14859.

[199] Tr. 4/7/03, p. 20.

corporation with which ProvGas would merge on September 28, 2000.[200] The Merger Settlement was signed on May 31, 2000. The Merger Settlement states clearly that in order not to "distort future cost of capital determinations for … ProvGas …the Companies", which includes ProvGas and Southern Union, "will propose the following alternatives for establishing an appropriate capital structure and associated capital cost rates for use in establishing rates for gas distribution service: Southern Union's actual consolidated capital structure …and a capital structure that reflects the capital structure for a comparable group of local gas distribution companies similar in risk to ProvGas".[201] The plain language of the Division-approved Merger Settlement clearly did not contemplate that ProvGas would have an "actual capital structure". There is no mention of ProvGas having an actual capital structure for ProvGas' "future cost of capital determinations". This Merger Agreement was approved by the Division in an order dated July 24, 2000. The ERI II Settlement was signed on August 2, 2000 between four settling parties, which included ProvGas, the Division and TEC-RI, who were also signatories to the Division-approved Merger Settlement. The ERI II Settlement established "future cost of capital determinations" for ProvGas for the period beyond the merger on September 28, 2000. As a result, the phrase "actual capital

[200] Order No. 16338, Division-approved Merger Settlement, p. 10.
[201] Id.

structure" in the ERI II Settlement, if applied to ProvGas, does not to appear to be consistent with the Division-approved Merger Settlement.

In addition, the Division has participated in all of the Commission proceedings in which the phrase "actual capital structure" was included in the Commission's orders. Specifically, on March 14, 2000, a few months prior to the ERI II Settlement, the Division and TEC-RI entered into the Narragansett Merger Rate Settlement approved by the Commission, in which the phrase "actual capital structure" was used in reference to Narragansett Electric. Narragansett Electric remained a corporation and a subsidiary after the merger. It is apparent that prior to the ERI II Settlement, ProvGas, the Division, TEC-RI, and the George Wiley Center had only entered into agreements relating to public utility regulation in which the phrase "actual capital structure" was used in reference to a corporation. An analysis of the parties' prior course of dealing thus indicates that the phrase "actual capital structure" should not apply to ProvGas during the ERI II period.

(iii) Subsequent Course of Performance

An analysis of the parties' subsequent course of performance requires a review of the use of the phrase "actual capital structure" and any discussion relating to ProvGas' capital structure and the capital structure of ProvGas' successor, NEGas. Prior to the proceedings in this docket, but after the ERI II Settlement was signed, ProvGas, NEGas, and the Division utilized the phrase "actual capital structure" in reference to

a corporation. In Docket Nos. 1673 and 1736, the Commission reviewed the need to reduce the interest rate applied by ProvGas to the deferred gas cost account.

At the January 23, 2001 hearing, approximately four months into the ERI II period, ProvGas opposed any reduction to the interest rate applied to the deferred gas cost account because of the effect it would have on the capital structure for ERI II earnings calculations. Mr. Oliver, the Division's witness, who also participated in the ERI II Settlement proceedings, indicated that ProvGas did not have a fixed capital structure under the ERI II Settlement. Instead, Mr. Oliver interpreted the ERI II Settlement to require the use of an actual capital structure for ProvGas. He stated that any increase in short-term debt due to a larger deferred gas cost account would be reflected in the actual capital structure.[202] It is interesting to note that Mr. Oliver made these comments after Mr. Hogan had testified that all short-term debt and long-term debt had been assumed by Southern Union as a result of the merger.[203] Even more telling was that ProvGas never indicated at the hearing through the cross-examination of Mr. Oliver, the direct testimony of Mr. Hogan, or argument by ProvGas' attorney, that Mr. Oliver was incorrect, and that ProvGas' had an actual capital structure of 100 percent common equity or a proxy capital structure of 50 percent debt and 50 percent equity. The silence is noted.

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[202] Tr. 1/23/01, pp. 129-130.

At the April 7, 2003 hearing in this docket, after reviewing of Mr. Oliver's January 23, 2001 testimony in Docket Nos. 1673 and 1736, Mr. Scialabba, the Division's Chief Financial Accountant, stated that he could not agree with Mr. Oliver's interpretation of the ERI II capital structure and could not recall why he did not take note of Mr. Oliver's testimony during the prior hearing.[204]

Subsequent to the January 23, 2001 hearing, on February 9, 2001, the Division and ProvGas entered into a settlement regarding an interest rate reduction for the deferred gas cost account. The parties agreed that ProvGas' average debt balance in the deferred gas cost account would be removed from the capital structure to determine ProvGas' earnings for the ERI II period.

In the current docket, Mr. Hogan indicated that ProvGas has an actual capital structure of 100 percent common equity and therefore, a 50/50 debt to equity capital structure should be used. As a result, he indicated that the Deferred Gas Cost Settlement Agreement would not be applicable.

When asked, Mr. Hogan concurred that when "the settlement was reached in ERI II," he "assumed that the capital structure for earnings was going to be 50 percent debt and 50 percent equity."[205] This raised a number of questions. For instance, if the language in the ERI II

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[203] Id. at 29-30.
[204] Tr. 4/7/03, pp. 101-102.
[205] Id., p.59.

Settlement was assumed to result in a 50/50 capital structure because ProvGas was supposed to have an actual capital structure of 100 percent common equity, then why did ProvGas litigate the issue of lowering the interest rate for the deferred gas cost account? Also, why was there a need to reach a settlement on this issue if the provisions of the Deferred Gas Cost Settlement relating to capital structure calculations would never be triggered?[206] Mr. Hogan's response was "the best I could do is guess," which suggested that there was uncertainty regarding ProvGas' post-merger capital structure.[207] This guess is not very persuasive.

In Docket No. 3401, the phrase "actual capital structure" was used repeatedly by NEGas and Division witnesses.[208] In making its rate filing as required by Commission Rule 2.8, NEGas, a division of Southern Union, had to provide information regarding its actual capital structure. In response, NEGas referred to Mr. John Dunn's pre-filed direct testimony. In Mr. Dunn's pre-filed direct testimony, the only actual capital structure discussed was Southern Union's actual capital structure. Mr. Dunn never indicated that ProvGas had an actual capital

[206] Tr. 4/7/03, p.59
[207] Tr. 4/7/03, pp. 62-63.
[208] NEGas objects to use of testimony from Docket No. 3401 in this docket. However, both the Division and NEGas have relied upon it when it furthered their positions. In developing the 50/50 proxy structure, Mr. Effron used the testimony of Mr. Kahal to determine the cost rates for debt and used Ms. Partridge's schedules in Docket No. 3401 to determine the appropriate long-term and short-term debt ratios of the 50/50 capital structure. Furthermore, NEGas cites Mr. Dunn and Mr. Kahal's testimonies in Docket No. 3401 to state that Southern Union's current post-merger capital structure was inappropriate for rate making. Recently, the Division utilized the testimony of

structure consisting of 100% common equity. In fact, Mr. Dunn stated that "as a division, New England Gas does not have its own capital structure."[209]

Also, in Docket No. 3401, Ms. Partridge indicated that ProvGas' actual capital structure for the rate year ending June 30, 2003 was the capital structure that existed prior to the merger when ProvGas was a corporation. It should be noted that the test year used in Docket No. 3401 was the year ending on September 30, 2000. Therefore, it appears that after the merger, NEGas considered ProvGas' actual capital structure to be a pre-merger capital structure.[210]

In Docket No. 3401, the Division referred to an actual capital structure in the pre-filed direct testimony of Matthew Kahal. In his testimony, Mr. Kahal indicated that NEGas is "a division and does not have an identifiable capital structure" and that Southern Union had an actual capital structure. Also, in response to a question posed in his pre-filed testimony regarding the most recent actual capital structure of ProvGas, Mr. Kahal referred to the pre-merger capital structure of ProvGas, which was 42.3 percent common equity, and not 100 percent

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other NEGas witnesses in other dockets in litigating Docket No. 3476 (Service Quality) without objection from NEGas.

[209] John Dunn's pre-filed testimony, p. 3.

[210] Order No. 17379; Sharon's Partridge's pre-filed testimony Schedule SP-2, 2 of 7. It should also be noted that on ProvGas' 2000 annual report for the year ending September 30, 2000, two days after the merger, indicated that ProvGas had long-term debt and not 100% equity. In other words, ProvGas did not view itself as having 100% equity when it was required to list its actual common stock and debt in its 2000 annual report for the year ending September 30, 2000. Instead it used its last actual capital structure as of September 27, 2000.

common equity. Furthermore, in his pre-filed testimony, Mr. Kahal opposed Mr. Dunn's recommendation of a 49.3 percent common equity ratio for NEGas because it would be "a significant increase from Providence/Valley pre-merger levels and previously approved by the Commission."[211] From this statement, Mr. Kahal, the Division's witness, seems to be unaware of the Division's view that in the ERI II Settlement, the Commission approved a 50 percent common equity ratio for ProvGas. This pre-filed testimony was filed on March 5, 2002.

At the May 6, 2002 hearing, in response to a question regarding the use of the "actuals" of ProvGas and Valley to develop a capital structure for NEGas, Mr. Kahal stated that the use of "actuals" was inapplicable because they were "no longer an independently financed company" and were "financially integrated with Southern Union". Furthermore, in response to a question regarding whether a proxy capital structure of 43.6 percent common equity "approximates the most recent level of equity for Providence Gas", Mr. Kahal stated that "by most recent … we mean most recent premerger; because it loses its meaning after the merger takes place."[212] It is apparent from Mr. Kahal's testimony that an actual capital structure would lose its meaning if it was applied to ProvGas after the merger.

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[211] Kahal's pre-filed testimony, pp. 6, 10-14. It should be noted that, in his pre-filed testimony, Mr. Dunn did not respond to Mr. Kahal's assertion that a 49.3 percent common equity rates was a significant increase by noting ProvGas had a 50 percent common equity ratio under ERI II Settlement.

[212] Tr. 5/6/02, pp. 60-61, 63-64.

Lastly, the parties in Docket No. 3401, NEGas (the successor of ProvGas), the Division and TEC-RI reached a settlement. These three parties were also parties to the ERI II Settlement. In the NEGas Merger Rate Settlement, under Section F.2 entitled "Capital Structure", the parties used the phrase "the Company's actual equity as shown for financial accounting purposes cannot be distinguished from that of Southern Union Company, as a result of the merger". The Company in the NEGas Merger Rate Settlement is NEGas, the successor of ProvGas and Valley. This should be compared to the second sentence in Section I.3 of the ERI II Settlement, which states "the Company's actual level of equity and total capital for financial accounting purposes will be affected by the pending merger with Southern Union." The Company referred to in the ERI II Settlement is ProvGas. According to Mr. Hogan at the April 7, 2003 hearing, NEGas has an actual capital structure, which for Rhode Island, is the total of the actual capital structures of ProvGas and Valley.[213] Thus, NEGas' current interpretation that ProvGas and therefore, NEGas, had its own actual capital structure during the ERI II period is contrary to the clear language in the NEGas Merger Rate Settlement.

In summary, reviewing the subsequent course of performance of the parties subsequent to the ERI II Settlement and prior to this docket, demonstrates that the interpretation that ProvGas had an actual capital

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[213] Tr. 4/7/03, pp.23-24.

structure during the ERI II period is inconsistent with the testimony presented by the Division and NEGas in Docket Nos. 1673 and 1736, and Docket No. 3401. Even more striking, an interpretation that ProvGas had a post-merger actual capital structure would render the Deferred Gas Cost Settlement inoperative and ineffective, and would also contradict the plain language of the NEGas Merger Rate Settlement. The ERI II Settlement Agreement should not be interpreted in a manner that would render subsequent agreements between the parties as ineffective or in error.

As for the subsequent course of performance in this docket, it is interesting to note that throughout Mr. Reed's direct testimony, he cites cases where the phrase "actual capital structure" is applied only to a corporation, but he never states that ProvGas or a division of a corporation has an actual capital structure. He only states "the actual capitalization of ProvGas is nearly 100% equity." He does not even suggest that ProvGas has 100% actual common equity.[214] In contrast, Mr. Kahal and Mr. Dunn, the capital structure experts in Docket No. 3401, have filed testimony regarding capital structure and cost of capital in a larger percentage of their cases. Surprisingly, however, the parties continued to rely upon Mr. Reed and Mr. Effron to justify their capital

[214] Mr. Reed has limited experience testifying on capital structure and cost of capital issues. Mr. Reed's resume indicates he has filed testimony or testified in 150-175 cases. He certainly has expertise as to gas regulation in general however he listed only approximately five or six cases in which he indicated he testified on cost of capital or capital structure with the last case being in Canada in 1993. It is apparent that like

structure interpretations of the ERI II Settlement at issue in this proceeding instead of providing capital structure experts, Mr. Kahal and Mr. Dunn, as witnesses.

In addition, NEGas relies heavily upon the 2001 ProvGas annual report. However, the 2001 ProvGas annual report was not properly "filed" with the Commission Clerk as required by Commission Rule 1.3(c).[215] There are numerous inconsistencies in the 2001 ProvGas annual report. The annual report for the year 2001 does not coincide with either ProvGas' former fiscal year or NEGas' current fiscal year. The 2001 annual report was filled with basic errors such as indicating that no corporation controls ProvGas but rather that ProvGas controls Southern Union. The balance sheet which purports to show that ProvGas is nearly 100% common equity, requires the listing of "common

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Mr. Effron, Mr. Reed does not generally testify to capital structure or cost of capital. His testimony is given limited weight.

[215] Prior ProvGas annual reports filed with the Commission contained a time stamp from the Rhode Island Public Utilities Commission. For instance, the ProvGas annual report filed for year ending September 30, 2000 has a time stamp indicating "RECEIVED 2001 MARCH 30 PM 3:45 PUBLIC UTILITIES COMMISSION". In contrast, the ProvGas annual report year ending December 31, 2001 has no time or date stamp on it. The Valley Gas 2001 annual report, which may have accompanied the ProvGas 2001 annual report, does have a date stamp on it. This stamp states "R.I. PUBLIC UTILITIES ACCOUNTING DEPT. APRIL 17, 2002 RECEIVED". This is not the time stamp of the Commission Clerk. It is unclear if it is a Division date stamp. These annual reports were simply placed in Docket No. 3401 and never marked or entered as an exhibit in the proceeding.

The apparent timing of the ProvGas annual report is also interesting. The Valley 2001 annual report was "filed" on April 17, 2002. Coincidentally, the original NEGas Merger Rate Settlement Agreement was filed with the Commission on April 29, 2002. This three year rate freeze settlement contained the language previously discussed regarding "actual equity" of NEGas as not being distinguishable from Southern Union. Possibly, NEGas filed this ProvGas 2001 annual report in anticipation of the difficulty it would have to prove ProvGas had an actual capital structure in this docket. Furthermore, it must have been apparent to NEGas by April 17, 2002 that ProvGas was not going to be reconstituted as a subsidiary by June 30,

stock" and "capital stock", not equity. Despite the fact that the 2001 ProvGas annual report indicated that ProvGas has no capital stock and included such a footnote at the bottom of the balance sheet, NEGas simply placed figures in the line items reserved for "common stock" and "capital stock" in an attempt to indicate ProvGas had "actual common equity". The 2001 annual report format utilized by ProvGas is a FERC format. It is apparent that this format uses the terms common stock and capital stock, and not common equity, so as to avoid this sort of creative accounting. The Commission places little to no weight on an annual report filled with such basic errors and inconsistencies, and which departs from general accounting principles including those utilized by FERC.[216] Furthermore, assuming the 2001 ProvGas annual report was properly filed, the Rhode Island Supreme Court has stated that "the commission is not bound by the company's account books for rate-setting purposes".[217] This unusual annual report with its unusual "filing" with the Commission is not persuasive.[218]

2002, the end of the ERI II period, and that Southern Union's actual capital structure could have significant implications in calculating ProvGas' earnings.

[216]Previously, this Commission has determined that a power contract entered into by Pascoag, a municipal electric utility corporation, had no "effect on Pascoag's capital structure" based on its review of "generally accepted accounting principles" including FERC's accounting principles, and how the commission has "historically" treated power contracts in relation to securities. Pascoag Fire District v. PUC, 636 A.2d 689, 690-691 (R.I. 1994).

[217] New England Telephone v. PUC, 446 A.2d 1376, 1388 (RI 1982).

[218] Furthermore, it should be noted that ProvGas has no annual report covering the period October 1 2000 to December 31, 2000 and had not filed a report for 2002 as of the date of the May 22, 2003 open meeting. On July 1, 2003, the day after the Commission's approval of NEGas' compliance filing in this docket, a 2002 annual report for NEGas was submitted to this Commission. Interestingly, in this annual report, NEGas did not place any amount in the line items reserved for common stock.

In regards to the NEGas allegation that ProvGas was required to maintain separate books and accounts relating to equity after the merger, Mr. Hogan could not cite a provision of the ERI II Settlement in support of this contention. He did cite Section C.2 of the Division-approved Merger Settlement Agreement. However, this provision only requires that Southern Union "provide access to information pertaining to Southern Union's operations as they relate to matters relevant to setting rates and providing oversight over the regulated operations of ProvGas".[219] The plain language of this provision does not appear to require ProvGas to maintain separate books relating to equity or capital structure.

b. Parties Interpretation of the Terms

NEGas' primary argument that ProvGas has an actual capital structure is based on the fact that the Division agrees with NEGas on this interpretation. It should be noted where the terms are ambiguous, a court will consider "the construction placed upon such terms by the parties themselves" as "an aid in determining their intended meaning."[220]

At the outset, it must be noted that there were four parties to the ERI II Settlement. In addition to NEGas and the Division, the other two parties were TEC-RI and the George Wiley Center. At the hearing on

[219] Order No. 16338, Division-approved Merger Settlement, p. 10., Tr.4/7/03, pp. 50-51, 70-71.
[220] Woonsocket Teachers Guild v. Sch. Com. 117 R.I. 373, 376 (1976).

April 7, 2003, Mr. Shelton indicated that at the time of the ERI II Settlement, he thought the Division or ProvGas had explained to him the meaning of Section I.3. When asked his intent behind Section I.3, Mr. Henry Shelton, on behalf of the George Wiley Center, indicated that "when the new company came in they would assume all the responsibilities…and all the agreements that were made before them". Mr. Shelton has participated in Commission proceedings extensively as a consumer group advocate. His answer does not suggest he assumed that ProvGas would somehow continue in existence after the merger. He certainly did not indicate that he intended that ProvGas would have its own actual capital structure or that a 50/50 proxy capital structure would be utilized. Instead, Mr. Shelton seemed to suggest that the "new company", Southern Union, would "assume all the responsibilities….and all the agreements" such as the ERI II Settlement. In other words Mr. Shelton's intent at least implied that Southern Union would step into the shoes of ProvGas.

The intent of the George Wiley Center, a party to the settlement, does not appear to be the same as NEGas or the Division. The George Wiley Center could have indicated clear support for NEGas' interpretation for ProvGas. It is quite telling that at the hearing neither NEGas nor the Division attempted to elicit a response from Mr. Shelton regarding his intent behind Section I.3. It suggests a concern that Mr. Shelton would not share their interpretation or intent for Section I.3.

The lack of clear and express support for the ProvGas interpretation from all four settling parties makes the meaning placed by two of the settling parties on the phrase "actual capital structure" of limited value.[221]

In addition, Mr. Hogan, who participated in the ERI II Settlement negotiations for ProvGas, indicated that the intent behind the ERI II Settlement was to maintain the status quo with respect to earnings and costs for ProvGas. According to Mr. Hogan, an increase in ProvGas' actual common equity ratio immediately prior to the merger from 42.3 percent to 50 percent common equity "maintains the status quo."[222] The interpretation that ProvGas had an actual capital structure, and therefore, that a 50 percent common equity ratio should be used for earnings calculations, seems to be in conflict with the intent that the ERI II Settlement was to maintain the status quo. If this is true, as much as an eight percent increase or decrease in the common equity ratio could be deemed as maintaining the status quo. Possibly, NEGas can not clearly express what its intent was regarding the ERI II Settlement.

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[221] TEC-RI's intent was not offered into evidence by NEGas or the Division, and TEC-RI did not respond to the Commission's invitation to appear at the hearing.

[222] Tr. 4/7/03, pp. 54-55. Assuming NEGas' calculation is correct that during the ERI I time period the average common equity ratio was 47.4 percent, it is still questionable whether a three percent increase in the common equity ratio maintains the status quo.

c. Circumstances Surrounding Approval of the Settlement

This leads to the next step in the analysis which is to review the circumstances surrounding the execution of the agreement. The ERI II Settlement was approved by the Commission at a time when the Commission was very concerned and displeased with ProvGas' failure to be proactive in gas procurement for the winter of 2000-2001.[223] In fact, the Commission reduced the ROE in the ERI II Settlement from 10.9 to 10.7 percent because of its displeasure with ProvGas' gas procurement. NEGas' interpretation that when the Commission approved the ERI II Settlement it automatically increased ProvGas' common equity ratio from 42% to 50% without making a corresponding decrease in the return on equity is illogical. A general ratemaking principle is the higher the common equity ratio the lower the return on equity. In light of the Commission's displeasure regarding ProvGas' gas procurement, any suggestion that the Commission would approve an increase in the common equity ratio while not requiring a corresponding decrease in the return on equity borders on the absurd, and is pure fantasy.

NEGas attempts to point to the Narragansett Electric Merger Rate Settlement of March 14, 2000 as indicative that ProvGas has an actual capital structure and that a 50/50 proxy capital structure was the intent behind Section I.3. However, the Narragansett Merger Rate Settlement was strikingly different. First, the Narragansett Settlement

[223] Order No. 16584, pp. 16-17.

clearly stated at the outset of the section relating to capital structure that an imputed (proxy) capital structure of 50% common equity, 5% preferred equity and 45% long-term debt was to be utilized. The reference to using an actual capital structure was secondary and referred to Narragansett Electric, which was, and still is, a corporate subsidiary. Second, Narragansett and the EUA electric companies all had actual capital structures with actual common equity ratios ranging from 52% to 57%. The proxy capital structure of 50% common equity ratio was an attempt by the Commission to reduce the utility's common equity.[224] On the other hand, NEGas' interpretation would result in ProvGas' common equity ratio increasing from 42% to 50%. This is exactly the opposite regulatory policy underlying the Narragansett Merger Rate Settlement.[225] Also, in the Narragansett Electric Merger Rate Settlement, the concern that Narragansett's actual common equity would be increased due to the acquisition premiums for the EUA companies was handled by creating a proxy capital structure. There was no need to create a proxy capital structure for ProvGas to prevent the inclusion of acquisition premiums because ProvGas was not acquiring Southern Union. Consequently, a review of the facts

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[224] Mr. Kahal's pre-filed testimony in Docket No. 2930, pp.14-18, Schedule MIK-1, page 4 of 4.

[225] The capital structures proposed by the Division in Docket No. 2930 and Docket No. 3401 were prepared by Mr. Matthew Kahal, a capital structure expert. Unfortunately, in Docket No. 2581 relating to ERI II and this docket relating to the interpretation of the ERI II Settlement, the Division did not retain the services of Mr. Kahal. Instead it relied on the expertise of Dave Effron on capital structure although Mr. Effron admitted he does not typically testify to capital structure. Tr. 4/7/03, pp. 93, 102.

surrounding the approval of the ERI II Settlement indicates that an interpretation that ProvGas has an actual capital structure is not reasonable.

d. Construed Against the Drafter

The rule that an ambiguity must be construed against the drafter does not assist NEGas. It is common practice at the Commission that settlement agreements are drafted by the utility. NEGas did not indicate that the ERI II Settlement departed from the common practice. Since interpreting the phrase "actual capital structure" to mean ProvGas is the most favorable to NEGas, this rule is of no assistance to NEGas.

e. Public Interest Interpretation

Lastly, there is the rule that an agreement affecting the public interest should be construed in favor of the public and/or the public interest. A settlement agreement establishing utility rates certainly is an agreement affecting the public interest. NEGas' interpretation to deem post-merger ProvGas as having an actual capital structure is the least favorable to the public and is contrary to the public interest. Of all the possible interpretations, only NEGas' interpretation results in a rate increase to ratepayers. As for the public interest, NEGas' interpretation would mean that by approving the ERI II Settlement, the Commission allowed ProvGas to increase rates by $4.5 million while increasing its common equity from 42% to 50% without appropriately reducing its return on equity in relation to that issue. This is also contrary to the

Commission's findings in the order approving the ERI II Settlement that ProvGas had failed to be proactive in gas procurement for the winter of 2000-2001 resulting in rate shock to ratepayers. NEGas' interpretation is not in the public interest and it is only in the best interest of Southern Union's shareholders.

Accordingly, the Commission rejects the interpretation that ProvGas had an "actual capital structure" after the merger for purposes of earnings calculations in the ERI II Settlement.

B. PROVGAS' LAST ACTUAL CAPITAL STRUCTURE

NEGas argues that the phrase "the actual capital structure" can only apply to ProvGas. The Commission has already determined that during the ERI II time period ProvGas did not have an actual capital structure because it was not an actual corporation. As a result, the Commission considered whether the language of the ERI II Settlement could be interpreted to use ProvGas' last actual capital structure before the merger. ProvGas' actual capital structure just prior to the merger was 42.3 percent common equity ratio, 41.6 percent long-term debt ratio and 16.0 percent short-debt ratio.

The first step is to determine if the language of the ERI II Settlement Agreement is clear and unambiguous if ProvGas' last actual capital structure is adopted. The phrase in the first sentence of Section I.3 indicates the use of "the actual capital structure". Thus, ProvGas' actual capital structure as it existed immediately prior to the merger

could be appropriate because ProvGas was an actual corporation on September 27, 2000. On that date ProvGas had actual common stock.

The primary difficulty in utilizing ProvGas' last actual capital structure is in applying the earnings calculations pursuant to Section I.2. The calculation of ProvGas' earnings was for the "Extended Term", or the period from October 1, 2000 to June 30, 2002. The calculation expressly allows for the consideration of "preferred dividends" and "the percentage of preferred stock". ProvGas' last actual capital structure contained no preferred stock. Also, the restriction on common equity applicable to rate base would have no meaning if ProvGas' last actual capital structure was used, since the last actual capital structure would not include acquisition premiums as a result of the merger. The use of ProvGas' last actual capital structure would render portions of Section I.2 inapplicable, or at least require some adjustment to the section. Accordingly, the use of ProvGas' last actual capital structure for construing the phrase "the actual capital structure" in Section I.3 would not be clear and unambiguous, but rather would render other provisions of the ERI II Settlement inoperative.

Assuming the phrase "the actual capital structure" is deemed ambiguous, then the Commission must utilize additional rules of contract construction. As to trade usage and prior dealing, when the Commission utilized an actual capital structure to calculate a utility's earnings it utilized the actual capital structure during the relevant time

period. For instance, the ERI I Settlement required the use of ProvGas' actual capital structure in existence during the ERI I period to calculate any earning sharings. The ERI I Settlement did not utilize a prior actual capital structure of ProvGas such as the ProvGas actual capital structure ordered in Docket No. 2286.

The construction placed on the phrase "actual capital structure" by the settling parties does not coincide with ProvGas' last actual capital structure interpretation. NEGas and the Division both oppose this interpretation. In addition, Mr. Shelton, on behalf of the George W. Wiley Center, stated that he assumed the "new company", Southern Union would assume all "responsibilities" and "agreements" of ProvGas. Mr. Shelton's intent does not suggest that he envisioned ProvGas' continued or prior existence as being particularly relevant to Section I.3. The Commission does note that Mr. Hogan, a NEGas witness, stated that the ERI II Settlement was intended to maintain the status quo. The use of ProvGas' last actual capital structure under the ERI I period could "maintain the status quo" for the ERI II period.

As discussed before, the utility drafted the ERI II Settlement Agreement and therefore a reasonable meaning must be construed against it. As a result, the ProvGas last actual capital structure interpretation could be construed against NEGas.

As noted earlier, the ERI II Settlement affects the public interest. ProvGas last actual capital structure would be more beneficial to the

ratepayers than NEGas' 50/50 interpretation because it would result in rates being lowered. Also, it would be in the public interest because this last actual capital structure was incorporated into the ERI I actual capital structure used to determine earnings sharing during the three year period of October 1, 1997 to September 30, 2000.

Overall, however, it is apparent that the clear language of the ERI II Settlement did not envision the use of ProvGas' last actual capital structure. As a result, the Commission must further examine other possible interpretations.

C. THE DOCKET NO. 3401 PROXY CAPITAL STRUCTURE

NEGas argued that the only actual capital structure that can be applied to the ERI II Settlement is a ProvGas actual capital structure. Also, NEGas indicated that if there was no ProvGas actual capital structure during the ERI II period then the entire ERI II Settlement Agreement would become inoperative under the contract principle of impossibility. The Commission does not agree.

It is clear that the parties intended to reach a settlement so that the Commission could approve the settlement in order to establish just and reasonable rates. The parties may have failed to foresee or make any provision in the event that ProvGas did not have an actual capital structure during the ERI II period. Furthermore, the ERI II Settlement Agreement affects the public interest. In these circumstances, the application of the doctrine of impossibility would be draconian and

unwarranted. Instead, the Commission could utilize the contract principle for omitted terms. If the parties omit an essential term the court can supply a term that is reasonable under the circumstances.

Utilizing the omitted term principle, the Commission could insert the proxy capital structure from Docket No. 3401. This proxy capital structure was used for NEGas for a three-year rate period beginning July 1, 2002. In Docket No. 3401, the proxy capital structure was agreed upon by three of the four parties to the ERI II Settlement. Also, the former ProvGas is a substantial portion of NEGas. It is apparent that the NEGas proxy capital structure could be reasonable under the circumstances. The proxy capital structure in Docket No. 3401 was appropriate for establishing just and reasonable rates for three years. It should be reasonable and in the public interest to substitute the proxy capital structure in place of an omitted term in the ERI II Settlement. Also, the proxy capital structure in Docket No. 3401 was used to establish an earnings sharing mechanism for ratepayers when the ROE rises above a certain level, just as the actual capital structure in the ERI II Settlement was designed to give ratepayers all earnings above a certain ROE.

However, there are problems with utilizing the proxy capital structure in Docket No. 3401 in this proceeding. First, the proxy capital structure was developed for the period after the ERI II time period, and therefore its use in this proceeding could be construed as retroactive

ratemaking. Also, the use of the omitted term principle is a rather significant remedy in contract law. It should only be used if there is not a reasonable interpretation that can be given to the clause in dispute. As a result, the Commission must determine if the phrase "the actual capital structure" in the ERI II Settlement applies to Southern Union.

D. SOUTHERN UNION CAPITAL STRUCTURE

In response to cross-examination by Commission staff, NEGas argued that the phrase "the actual capital structure" in the ERI II Settlement does not apply to Southern Union. In reviewing this position, the first step is to determine if the phrase "the actual capital structure" is clear and unambiguous if it is interpreted to mean Southern Union.

1. Clear and Unambiguous Approach

a. Plain, Ordinary and Usual Meaning

As indicated previously the plain, ordinary, and usual meaning of "actual capital structure" means the common stock, preferred stock and debt of an actual corporation. During the entire ERI II period, there was only one corporation doing business in the State of Rhode Island as a natural gas utility. This corporation was Southern Union. It did business under the fictitious business name of ProvGas.[226]

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[226] Documentation of the R.I. Secretary of State.

b. Technical Meaning

As discussed earlier, the technical meaning of the phrase "actual capital structure" in a rate making context applies to a corporation, and not to a division of a corporation. As indicated above, the only corporation providing gas utility service in Rhode Island during the ERI II time period was Southern Union.

c. Consistent with Other Provisions

The next step in the analysis is to determine if the use of Southern Union's capital structure is consistent with other provisions of the ERI II Settlement. NEGas argued that the plain, ordinary, and usual meaning of the phrase "actual capital structure" in the ERI II Settlement only applied to ProvGas. The clear wording of the ERI II Settlement indicates that this is incorrect. The first sentence of Section I.3 states: "The Company will use the actual capital structure and associated costs of capital in determining its earned return on equity." The Company, of course, is ProvGas, and the word modifying the "earned return on equity" is "its" a possessive pronoun clearly indicting ProvGas' return on equity. However, the word modifying the phrase "actual capital structure" is the word "the" not "its". The word "the" is an article rather than a possessive pronoun. Certainly, if the drafter of this sentence had intended to limit the meaning of the phrase "actual capital structure" to ProvGas, the drafter would have used the word "its" to modify the phrase "actual capital structure". In the same sentence, the drafter of

this sentence was careful to use the words "its" to modify the phrase "earned return on equity" so as to clearly indicate ProvGas. The clear failure of the drafter to use the words "its" to modify the phrase "actual capital structure" suggests a clear and objective intent to possibly use an actual capital structure other than that of ProvGas.

In regards to other provisions of the ERI II Settlement, Section I.2 entitled Calculation of Return on Equity states:

> The return on common equity will be calculated by dividing the net income available for common equity by the common equity applicable to rate base…less applicable interest and preferred dividends (if any)…The applicable interest shall be calculated by multiplying average rate base by the percentage debt in the capital structure…times the applicable cost rate, and the applicable preferred dividends, if any, shall be calculated by multiplying average rate base by the percentage of preferred stock in the capital structure times the applicable cost rate. The common equity applicable to rate base shall be calculated by multiplying the actual common equity ratio…by rate base.

It is clear that this provision envisions the use of a corporation's actual capital structure. Again, the only corporation in existence during the ERI II period providing gas utility service in Rhode Island was Southern Union. Prior to the merger and during the ERI II period, Southern Union had "preferred stock" and paid "preferred dividends". It also had an "actual common equity ratio" because it had actual common stock. Thus, it appears that the provision refers to Southern Union.

The use of the phrase "common equity applicable to rate base" provides further evidence that the phrase "the actual capital structure" was intended to mean Southern Union and not ProvGas. If it was

envisioned that common equity was to be used to pay for acquisition premiums that would have meant Southern Union and not ProvGas. It was Southern Union who was paying acquisition premiums to purchase ProvGas. The requirement to exclude acquisition premiums from common equity in the capital structure is also a departure from the ERI I Settlement which simply required the use of the actual capital structure. In the ERI II Settlement, there was a concern about the effects of the pending merger with Southern Union as evidenced by the inclusion of a provision to exclude acquisition premiums from common equity calculations. This exclusion of acquisition premiums from the common equity earnings calculation would not have referred to ProvGas, the corporation being acquired. It refers to the corporation expending acquisition premiums in the merger--Southern Union.

The Southern Union interpretation of the phrase "the actual capital structure" coincides with the other two sentences of Section I.3. The second sentence simply makes a prediction. It states: "However, the Company's actual level of equity and total capital for financial accounting purposes will be affected by the pending merger with Southern Union." This prediction came true. ProvGas' "actual level of equity" ceased to be separately identifiable when it ceased to be a corporation with actual stock. The third sentence states: "Therefore, if ProvGas' actual average common equity ratio is above 50% for any reporting period during the Extended Term, then the Company shall use

a capital structure consisting of 50% debt and 50% equity." This sentence is a contingency provision. During the ERI II period, if ProvGas had been a corporation with common stock and its "actual average common equity ratio" was above 50 percent, then a 50 percent debt/50 percent equity proxy capital structure would result. It is clear that the third sentence is a contingency provision because it is the last sentence in the paragraph and the sentences starts out with the word "if". If, as NEGas claims, the intent was always to use the 50 percent debt /50 percent equity capital structure then the drafter would have used the word "when" instead of "if" to preface the sentence. With the phrase "the actual capital structure" in the first sentence of Section I.3, it is clear that the drafter intended Southern Union's actual capital structure to be used unless ProvGas was a corporate subsidiary during the ERI II period and its "actual" common equity ratio exceeded 50 percent, at which point a 50 percent equity/50 percent debt proxy capital structure would then be used.

After a review of all the evidence and application of the appropriate rules of law, it is clear and unambiguous that the phrase "the actual capital structure" in the ERI II Settlement refers to Southern Union. This is the only interpretation that does not require the Commission to render other provisions of the ERI II Settlement inoperative or making a finding that an omitted term exists.

However, in the event the phrase “the actual capital structure” could be considered to be ambiguous, the Commission will utilize other rules of contract construction to determine if “the actual capital structure” refers to Southern Union.

2. Ambiguous Approach

a. Subsequent Performance, Course of Dealing, and Trade Usage

(i) Trade Usage

As pointed out earlier, reviewing the trade usage in Rhode Island of the phrase “actual capital structure”, the Commission has always utilized this concept in reference to an actual corporation. Also, the other two Rhode Island major investor owned utilities utilize the phrase “actual capital structure” in reference to an actual corporation. In addition, the Rhode Supreme Court has used the phrase “capital structure” for ratemaking purposes in reference to an actual corporation.

NEGas has argued that it is inappropriate to consider or utilize the parent corporation for a division’s capital structure in developing the division’s rate of return. However, Rhode Island public utilities regulation has allowed for the application of a parent corporation’s capital structure to set the capital structure for a subsidiary or division. The Rhode Island Supreme Court has upheld this Commission on at least three occasions when it looked to the capital structure of a parent

corporation in setting rates for the subsidiary.[227] FERC and state commissions in 22 states have followed this approach as well.[228] Strangely, Mr. Effron, the Division's witness, indicated that he was unaware of a commission relying on the capital structure of the parent company to set a capital structure for a division or subsidiary.[229] Clearly, adopting a parent corporation's capital structure in setting rates for its division is appropriate. Utilizing the Southern Union actual capital structure would not depart from Commission ratemaking principles.

(ii) Prior Course of Dealings

As indicated previously, the phrase "actual capital structure" has been used by the parties only in reference to a corporation prior to the ERI II Settlement. The Merger Settlement filed on June 1, 2000, which was approved by the Division on July 24, 2000, clearly states that in "future cost of capital determinations… for ProvGas … the Companies," which includes ProvGas and Southern Union, "will propose the following alternatives for establishing an appropriate capital structure and associated capital cost rates for use in establishing rates for gas distribution service: Southern Union's actual consolidated capital

[227] Wakefield Water Co. v. Burke, 502 A.2d 816, 818 (R.I. 1986); New England Telephone Co. v. PUC, 459 A.2d. 1381, 1386-1387 (R.I. 1983); Bristol County Water v. Harsch, 120 R.I. 223, 232-239 (1978). In Wakefield, the R.I. Supreme Court upheld the Commission when it "imputed the capital structure of the parent corporation to Wakefield", a subsidiary. 502 A.2d at 818.
[228] Randy R. Koenders, Annotation, Propriety of Considering Capital Structure of Utilities' Parent Company or Subsidiary in Setting Utilities' Rate of Return, 80 ALR 4th 280, 288-290.

structure" and a proxy group of companies.[230] This language is almost identical to the language in a data request issued to Southern Union by the Division on April 10, 2000 and attached to Mr. Richard LeLash's direct testimony on behalf of the Attorney General and the Advocacy Section of the Division in the Division's merger proceeding. The Division's data request asked Southern Union to "provide a description of how Southern Union will determine the weighted costs of capital for

(iii) Subsequent Course of Performance

At the January 23, 2001 hearing, Mr. Hogan clearly indicated that ProvGas had no actual short-term debt but that Southern Union did have short-term debt. When Mr. Hogan testified that there was a fixed capital structure under the ERI II Settlement, Mr. Oliver, the Division's witness, disagreed. He stated the ERI II Settlement was "based on the actual capital structure, not one that was assumed at a point in time."[232] Mr. Oliver indicated that if the short-term debt level increased in the capital structure, it would be reflected in the actual capital structure. After reading this comment, Mr. Scialabba could not explain Mr. Oliver's answer and could only voice his disagreement with it at the time of April 7, 2003 hearing in the current docket.

As a result of the January 23, 2001 hearing, the Division and the gas companies signed a Deferred Gas Cost Settlement Agreement on February 9, 2001. In the Deferred Gas Cost Settlement Agreement, the parties indicated that, for ProvGas' earnings calculated under the ERI II Settlement, "the short-term debt portion of the capital structure shall be adjusted to exclude that portion of average short-term debt balance associated with the average deferred gas cost balance." Conspicuously, there is no mention of ProvGas' actual capital structure. Instead, a capital structure with a short-term debt component that can be adjusted to exclude the average deferred gas cost balance is referred to

[232] Tr. 1/23/01, pp. 29-30, 129- 130.

in the Deferred Gas Cost Settlement. The only capital structure in existence during the ERI II period that had a short-term debt component which funded ProvGas' deferred gas cost account was Southern Union's capital structure. It is not surprising that, in the portions of its order referring to or approving the Deferred Gas Cost Settlement Agreement, the Commission never discussed a ProvGas capital structure. Instead, the Commission specifically addressed Southern Union and indicated that the Commission had the authority to deny carrying costs for deferred gas cost accounts.[233] If ProvGas and the Division really believed that ProvGas had an actual capital structure of 100% common equity after the merger, then the Deferred Gas Cost Settlement would have been completely unnecessary. Certainly, four months after the merger, ProvGas should have known whether it had an actual capital structure of 100% common equity. Apparently, ProvGas reached a settlement with regard to deferred gas costs to ameliorate any effect the reduction in short-term debt rates would have upon Southern Union's actual capital structure and, therefore, on ProvGas' earnings calculations.

In Docket No. 3401, the capital structure experts of both NEGas and Division only referred to Southern Union as having an actual capital structure. Under Commission Rule 2.8, a utility is required to provide information as to its actual capital structure. NEGas responded by

[233] Order No. 15745, pp. 48, 66.

referring to Mr. John Dunn's pre-filed testimony. In his pre-filed testimony, he only referred to Southern Union as having an actual capital structure.

In Docket No. 3401, the Division relied on its capital structure expert, Matthew Kahal. In his pre-filed testimony, he indicated that Southern Union had an actual capital structure. Most importantly, in referencing prior Commission rate making for ProvGas, Mr. Kahal stated that "a 49.3 percent common equity ratio" would be "a significant increase from the Providence/Valley pre-merger levels and levels previously approved by the Commission."[234] Clearly, Mr. Kahal did not believe the Commission had approved a 50% common equity ratio for ProvGas in the ERI II Settlement. At the May 6, 2002 hearing, Mr. Kahal indicated that Southern Union had an actual capital structure.[235]

Also, in the NEGas Merger Rate Settlement Agreement, NEGas, the Division and TEC-RI indicated that NEGas' "actual equity as shown for financial accounting purposes cannot be distinguished from that of Southern Union Company, as a result of the merger." In other words, Southern Union has "actual…equity" while any actual equity in NEGas cannot be distinguished for accounting purposes from Southern Union. Until it came time to calculate ProvGas' ERI II earnings in Docket No. 3459, both NEGas and the Division indicated that the only gas

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[234] Kahal's pre-filed testimony, pp. 6, 10-14.
[235] Tr. 5/6/02, p. 55.

distribution utility in Rhode Island having an actual capital structure during the ERI II period was Southern Union.[236]

b. Parties' Interpretation of the Terms

As noted earlier, the primary argument of NEGas is that the Division agrees with the interpretation of a 50% debt/50% equity capital structure and that it disagrees with a Southern Union interpretation. As discussed previously, the construction placed on the terms by the parties themselves is merely "an aid" and that a court "will consider" it. Rhode Island law does not mandate a court to adopt the interpretation of the parties. This is particularly true for the Commission. Settlement agreements approved by the Commission are incorporated into its orders setting just and reasonable rates. The Commission must be able to enforce a reasonable interpretation of an order and an accompanying settlement. Otherwise, when approving a settlement, the Commission and the ratepayers could find themselves at the mercy of the subjective, unexpressed intent, of some of the parties at some point in the future. The public interest would not be determined by a Commission interpretation of its order and incorporated settlement but rather, by the whims of a utility or some other party.

As previously noted, only two of the four parties to the ERI II Settlement oppose the Southern Union interpretation. TEC-RI has not expressed an opinion. However, Mr. Shelton, on behalf of the George

[236] It is interesting to note the Division did not present Mr. Kahal and NEGas did not

Wiley Center, seemed to express an intent consistent with a Southern Union interpretation. He indicated that "when the new company", Southern Union, "came in they would assume all the responsibilities…and all the agreements that were made before them." In reference to a section entitled "Capital Structure" Mr. Shelton refers to the "new company", Southern Union. Mr. Shelton is a consumer advocate not a capital structure expert. However, his intent has the same value as any other settling party. When it comes to capital structure, Mr. Shelton thought of the "new company" as Southern Union.

As for Mr. Hogan's statement that the ERI II Settlement was intended to maintain the status quo in regards to earnings, Southern Union's actual capital structure approximates the pre-merger status quo about as well as the 50 % debt/50% equity capital structure. ProvGas had 42.3 percent common equity immediately prior to the merger. Southern Union's actual common equity during ERI II period was 31.1 percent or approximately an 11 percent decrease, while a 50% proxy common equity ratio would be approximately an 8 percent increase. Lastly, the 50/50 proxy capital structure only calls for 50 percent equity. Equity can be common or preferred. The Division and NEGas have chosen to equate 50% equity with 50% common equity. During the ERI II period, Southern Union's actual equity level (common and

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present Mr. Dunn in Docket No. 3459.

preferred) is 36 percent only 6 percent below ProvGas pre-merger actual equity level (all common) of 42 percent, while the 50 percent proxy equity level is 8 percent above the pre-merger level. As a result, Southern Union's actual equity level is closer to ProvGas' pre-merger equity level than the 50% proxy equity level.

c. Circumstances Surrounding Approval of the ERI II Settlement

As for the circumstances surrounding the approval of the ERI II Settlement, it is apparent that Southern Union would have been an appropriate interpretation of the phase "the actual capital structure". Southern Union's actual capital structure prior to the merger with ProvGas had 46.8 percent common stock and 6.3 percent preferred stock.[237] Prior to September 2000, Southern Union had a very strong capital structure, in fact, it was one weighted towards equity. Prospective rates based on a 10.7 percent return on common equity would certainly be fair and reasonable for an actual capital structure with 46.8 percent common stock. Furthermore, the restriction in the ERI II Settlement on the application of common equity to rate base would have ensured that if Southern Union's actual common equity rates dramatically increased due to acquisition premiums, then Rhode Island ratepayers would not be harmed when ProvGas' earnings calculations were performed.

[237] Dunn's pre-filed testimony, p. 8.

Also, the ERI II Settlement provided the additional contingency that if ProvGas became a subsidiary of Southern Union during the ERI II period and its actual common equity exceeded 50%, then a 50/50 proxy capital structure would be utilized.

NEGas raises the argument that it was envisioned prior to the merger that ProvGas was to become a division of Southern Union, as indicated in the Division merger approval order. The Commission notes that the Division and ProvGas use the word "division" and "subsidiary" very loosely and interchangeably. For instance, on June 15, 2001, nearly nine months after the ProvGas merger, the Division and the New England Division of Southern Union signed a Gas Purchase Prudence Review Settlement indicating that "on September 28, 2000, ProvGas also became a wholly-owned subsidiary of Southern Union Company."[238] Ms. Partridge tried to explain this by stating that at some point on September 28, 2000 ProvGas was a subsidiary and then it became a division later that day. Assuming this is true, the parties should have used the word "was" instead of "became" to note that it was a subsidiary only momentarily on September 28, 2000. Possibly, NEGas and the Division had an "undisclosed intent" to consider ProvGas as subsidiary of Southern Union and, therefore, believed ProvGas had an "actual capital structure". However, this Commission is aware of the difference under Rhode Island law between a subsidiary with its own common

[238] Order No. 16745, Gas Purchase Prudence Review Settlement, p. 3.

stock and a corporate division which has no stock in its own name. The Commission is well aware that only an actual corporation can have an actual capital structure for purposes of public utility regulation.

Assuming the parties understood that ProvGas would cease being a corporation on September 28, 2000, Southern Union could have reconstituted ProvGas as a subsidiary corporation with its own actual capital structure during the 21-month period of ERI II. Under those circumstances, the third sentence of Section I.3 is a true contingent provision in that it provided for a 50/50 capital structure if Southern Union reconstituted ProvGas as a corporate subsidiary during the ERI II period and ProvGas' actual common equity was above 50 percent. Southern Union could have followed this approach under the ERI II Settlement and triggered the contingency in the third sentence of Section I.3. However, Southern Union did not choose this option.[239] Interestingly, reflecting upon the need for the Deferred Gas Cost Settlement of February 9, 2001, Mr. Hogan indicated that "we weren't sure what was going to happen to the capital."[240] It seems that in February 2001, Mr. Hogan wasn't sure in what form ProvGas would exist during the ERI II period.

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[239] If Southern Union had made ProvGas a corporate subsidiary, Southern Union would have been subject to the stringent regulation and requirements of the Public Utility Holding Company Act that was enacted during the New Deal era after the collapse of highly debt leveraged energy holding company empire of Samuel Insull.
[240] Tr. 4/7/03, pp. 62-63.

d. Construed Against the Drafter

When drafting the ERI II Settlement, ProvGas did so in a manner that provided Southern Union with various options to pursue during the ERI II period and various meanings from which to choose when it came to calculating ProvGas' ERI II earnings following the conclusion of the ERI II period. For instance, Southern Union's actual capital structure could be utilized. Also, ProvGas could have become a corporate subsidiary with more than 50% actual common equity. In addition, Southern Union could attempt to construe ProvGas as having an actual capital structure with 100% common equity in order to utilize a 50% equity/50% debt capital structure. Unfortunately, for NEGas, Southern Union utilized debt instead of common equity for the acquisition of ProvGas and, during the ERI II period, did not issue enough common equity to create a more balanced capital structure. Furthermore, ProvGas did not become a corporate subsidiary of Southern Union, and therefore did not have an actual capital structure. Consequently, less than three months before the end of the ERI II period, NEGas, on behalf of ProvGas, "filed" a 2001 annual report purporting that ProvGas had 100% actual common equity in an attempt to trigger the 50/50 capital structure contingency provision of the ERI II Settlement Agreement.

When there are numerous meanings that can be placed on a contractual term or phrase, the ambiguity must be construed against the drafter. ProvGas was the drafter of the ERI II Settlement Agreement,

therefore, any ambiguities therein must be construed against NEGas. Consequently, Southern Union's actual capital structure must be utilized in determining ProvGas' earnings during the ERI II period. This contract principle is particularly important in the context of agreements affecting the public or public interest. If the ambiguities in a settlement agreement were not construed against the drafter, then the Commission and the public would be at the mercy of the utility's interpretation placed on ambiguities created by the utility in the first place. During the proceedings for approving the ERI II Settlement, the parties had the opportunity to explain all aspects of the ERI II Settlement. The parties chose not to explain the provision relating to capital structure. Accordingly, the Commission must now construe this provision against the drafter of the ERI II Settlement. The fact that the Division concurs with NEGas' interpretation does not mean that the public interest is protected. Only the Commission protects the public interest through setting just and reasonable rates.

e. Public Interest Interpretation

As emphasized previously, a settlement agreement establishing utility rates is an agreement affecting the public interest. Consequently, the ambiguities in the agreement must be construed in favor of the public and/or the public interest. This rule rests more on the considerations of public policy than on the probable intention of the parties. Consequently, the intents of the four settling parties are given

less weight. Utilizing Southern Union's actual capital structure would certainly favor the ratepayers in part because it would result in greater ERI II period earnings being returned to ratepayers.

NEGas argues that the use of Southern Union's capital structure would be retroactive ratemaking. NEGas is incorrect. It is NEGas' proposed 50/50 proxy capital structure which would constitute retroactive ratemaking. In this proceeding, the Commission is not setting prospective rates but merely interpreting its prior order and the settlement agreement incorporated therein. It was this order that established these rates on a prospective basis. When the Commission reviewed and approved the ERI II Settlement Agreement, the actual capital structure of Southern Union consisted of 46.84 percent actual common equity. It is clear that Southern Union's actual capital structure prior to the merger with ProvGas was strong and comparable to ProvGas' actual capital structure during the ERI II period. Thus, the Commission's establishment for ProvGas of a 10.7 percent ROE was appropriate. Also, the restriction placed in Section I.2 limiting the earnings calculation of ProvGas to the common equity applicable to rate base provided assurance to the Commission that Southern Union's common equity ratio would not dramatically increase as a result of the merger. Although the actual common equity ratio in Southern Union's actual capital structure may have increased because of the payment of acquisition premiums, ratepayers would not be deprived of an

appropriate share of ProvGas' earnings because, under Section I.2, the common equity ratio applied to rate base would not dramatically increase. In other words, ratepayers would not experience a decrease in their share of ProvGas' potential over-earnings even if Southern Union's actual common equity ratio increased due to payment of acquisition premiums as a result of the upcoming merger. Accordingly, when ProvGas rates were set in September 2000, Southern Union's pre-merger actual capital structure of 46.8 percent common equity, taken together with the ERI II Settlement's protection for ratepayers against Southern Union's actual common equity ratio increasing due to acquisition premiums and a 10.7 percent ROE, produced a fair rate of return for the shareholders.

The fundamental failure in Mr. Reed's testimony is that he bases ProvGas' rate of return for the ERI II period on Southern Union's current 32% common equity ratio instead of the 46% common equity ratio that existed before the merger when prospective rates for ProvGas were set. Ratemaking is prospective, not retroactive. As noted above, Southern Union had an actual common equity ratio of 46.8 percent and not 31 percent at the time the ERI II Settlement was approved by the Commission.

Furthermore, in comparing a 32 percent common equity ratio to a 50% common equity ratio, Mr. Reed argued that a 32 percent equity capital structure creates a wider range of possible earnings outcomes

than 50% equity capital structure. However, a 50% common equity capital structure has a ROE mean of 10.68 percent and a ROE median of 10.67 percent. In comparison, a 32% common equity capital structure has a ROE mean of 10.67 percent and a ROE median of 10.66 percent. They are almost identical to one another and to the 10.70 percent ROE established in the ERI II Settlement.[241]

Unfortunately, for NEGas, Southern Union's actual common equity ratio during the ERI II period declined from 46.8 percent to 31 percent. In retrospect, a 10.7 percent ROE may not appear to be particularly appropriate for a 31 percent common equity ratio. However, this Commission must set rates prospectively and Southern Union's pre-merger actual capital structure had a 46.8 percent common equity ratio that was appropriate for prospective ratemaking. In contrast, NEGas' 50/50 capital structure interpretation is a form of retroactive ratemaking. NEGas developed a bizarre interpretation that ProvGas, a division, has an actual capital structure of 100% actual common equity so that a 50/50 proxy capital structure would result. NEGas' interpretation is a desperate attempt to avoid the consequences of the plain language of the ERI II Settlement—"use the actual capital structure."

[241] Tr. 4/7/03, pp. 88-90. In addition, Mr. Reed's 32 percent common equity capital structure contains no preferred equity. In contrast, there was approximately 4 percent preferred equity during the ERI II period for Southern Union.

NEGas notes the testimony of Mr. Kahal arguing that a 31 percent common equity capital structure is weak and that the Commission did not use Southern Union's actual capital structure in Docket No. 3401. NEGas is correct and possibly, if Southern Union's actual common equity in the capital structure before the merger in September 2000 was at 30 percent, the Commission could have rejected the use of an actual capital structure and established a proxy capital structure. Importantly, however, prior to the merger when the ERI II Settlement was being reviewed, Southern Union had a healthy actual capital structure containing 46.8 percent common equity.

In any case, other state commissions have adopted a common equity ratios below 40 percent. For instance, the Minnesota Court of Appeals upheld the Minnesota Public Utilities Commission when it utilized the actual capital structure of the parent corporation which had 37.8 percent common equity ratio because the gas utility division did "not have its own capital structure of its own".[242] The Minnesota Commission rejected the administrative law judge's determination that the actual capital structure of the parent corporation was unreasonable because "the common equity component" of the parent "was temporarily low as a consequence of its corporate acquisition program".[243] Instead, the Minnesota Commission ordered that the actual capital structure of the parent corporation should be used although it had a common equity

[242] Application of Peoples Natural Gas Co., 413 N.W. 607, 612 (Minn. App. 1987).

ratio of 37.8 percent.[244] Furthermore, NEGas should be aware that this Commission has utilized actual capital structures with an actual equity ratio ranging between approximately 30 to 35 percent.[245] While 31 percent common equity capital structure may raise concerns, it does not automatically make it impossible to have a fair rate of return.

The prohibition against retroactive ratemaking is a rule generally applied to prevent utilities from seeking rate relief for past errors or losses. The Rhode Island Supreme Court has declared that the "rule against retroactive ratemaking" has "two basic functions," which "are to protect the public by ensuring that it will not be forced to pay past company deficits in future payments and also to prevent the company from employing future rates to ensure its stockholders' investments."[246] In this case, NEGas is essentially seeking retroactive rate making and relief from the Commission order incorporating the ERI II Settlement. Southern Union has an actual capital structure with a low percentage of common equity. This is a result of management prerogative and economic conditions. If Southern Union had chosen to fund its acquisition premiums with more common equity and less debt, a more normal actual capital structure would have been produced. The choice to do otherwise and the consequences on Southern Union's capital

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[243] Id.
[244] Id. at 613.
[245] See e.g. Order No. 10857, Bristol County Water Co., Order No. 10404, Block Island Power Co.; Order N. 10372, Newport Electric Co.
[246] Narragansett Electric Co. v. Burke, 505 A.2d. 1147, 1148 (R.I. 1986).

structure was Southern Union's doing, not the Commission's action. A corporation may not wish to issue more common stock because of economic conditions. It may also elect not to issue more common stock in order to avoid diluting management control or reducing the value of the holdings of current common stockholders.[247]

structure during ERI II period, that risk is for the shareholders of Southern Union, and not for the ratepayers of Rhode Island to absorb.

ProvGas took a risk in entering into the ERI II Settlement: it agreed to base its earnings calculations on an actual capital structure. ProvGas followed the same approach in its prior ERI I Settlement. In contrast, Narragansett Electric based its earnings calculations on a proxy capital structure specifically defined in the Narragansett Merger Rate Settlement Agreement. NEGas adopted a similar proxy capital structure approach in Docket No. 3401. The risk of utilizing an actual capital structure is that it fluctuates over time. The common equity ratio in an actual capital structure may dramatically increase or decrease. As a result, an earnings calculation may allow the company to retain or lose an unexpected share of earnings. In contrast, a proxy capital structure is fixed with a specific common equity ratio therefore making earnings calculations and shareholders' earning sharing more predictable. In addition, a proxy capital structure specifies the cost rates for long term debt and preferred equity, while with actual capital structure the cost rates are to be determined in the future.

Under the ERI I Settlement, a healthy common equity ratio and warm winters caused ProvGas shareholders to retain all earnings. Thus, the ratepayers did not receive any share of ProvGas' ERI I earnings. During the ERI II period, ProvGas' luck ran out. A warm

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[249] Market Street Railway Co. vs. Railroad Commission, 324 U.S. 548, 567 (1945).

winter and a dramatic decrease in the actual common equity ratio, due presumably to a combination of Southern Union's managerial prerogative and economic conditions, resulted in ProvGas' ratepayers receiving earnings sharing. Surprisingly, however, when it came time to pay the ratepayers, NEGas indicated in its August 1, 2002 filing that the ratepayers were entitled to nothing. ProvGas took the risk, and now the shareholders of Southern Union have to pay the price.

The phrase "the actual capital structure" clearly and unambiguously refers to the corporation providing gas utility service in Rhode Island during the ERI II time period under the fictitious business name of ProvGas. That corporation is Southern Union. Even assuming that the phrase in question or other provisions of the ERI II Settlement are ambiguous, the best reasonable meaning of the phrase "actual capital structure" is Southern Union. These Commission findings are consistent with law and are based on facts and evidence and in the public interest.

E. <u>ADJUSTMENTS TO THE SOUTHERN UNION CAPITAL STRUCTURE AND THE NEGAS SETTLEMENT OFFER</u>

1. Deferred Gas Cost Adjustment

NEGas has requested various adjustments to the Southern Union actual capital structure if the Commission utilizes it for calculating ProvGas' earnings during the ERI II period. First, NEGas stated that the Southern Union actual capital structure must be adjusted to remove the ProvGas average deferred gas cost balance during the ERI II time period

for ProvGas. NEGas' request is consistent with the Deferred Gas Cost Settlement of February 9, 2001. As noted earlier, this subsequent settlement modifies the ERI II Settlement. As a result, the Deferred Gas Cost Settlement must be applied to the ERI II actual capital structure.

The ProvGas deferred gas cost balance was approximately $15,589,244 for the ERI II period. The issue is whether the deferred gas cost balance should be removed directly from the Southern Union actual capital structure or should be removed after the Southern Union capital structure ratios are applied to the ProvGas rate base. It is clear that the deferred gas costs to be removed from the capital structure pursuant to the Deferred Gas Cost Settlement refer to ProvGas' deferred gas costs and not the total Southern Union deferred gas costs. Accordingly, it appears more appropriate to remove the ProvGas' deferred gas costs from the capital structure after the Southern Union capital structure ratios are applied to the ProvGas rate base.

By doing so a greater percentage of short-term debt is removed from the capital structure, thereby reducing the potential ProvGas over-earnings. This Deferred Gas Cost Settlement is a modification to a prior agreement. Modifications to prior agreements are allowed if there is consideration. In the Deferred Gas Cost Settlement, the consideration for reducing the deferred gas cost interest rate was to exclude the average ProvGas deferred gas cost from short-term debt portion of the capital structure. This application of the removal of ProvGas deferred

gas costs from the capital structure for purposes of calculating the over-earnings of ProvGas is fair to NEGas, and will ensure that NEGas will receive the benefit of the bargain.

2. Unregulated Operations

NEGas requested another adjustment that would exclude the capital associated from the unregulated operations of Southern Union from the actual capital structure. NEGas acknowledged that these operations consist of a very small portion of Southern Union's overall operations. In fact, NEGas' witness, John Reed, did not remove these operations from the capital structure "because they were judged to be *de minimis*".[250] Neither the ERI II Settlement Agreement nor the Division-approved Merger Settlement expressly calls for their exclusion from the earnings calculation. Accordingly, the Commission will include the capital of these unregulated operations in the actual capital structure because their exclusion would have a *de minimis* impact on the capital structure, and their removal is not required under the ERI II Settlement.

3. Acquisition Premiums

NEGas strongly urges that the equity and debt used to pay acquisition premiums be excluded from the Southern Union's actual capital structure for calculating ProvGas' earnings. NEGas' expert, Mr. Reed, indicated that the ERI II Settlement Agreement does not address whether the acquisition premiums should be excluded from the capital

[250] Tr. 4/7/03, p. 84.

structure.[251] A review of the ERI II Settlement Agreement indicates that acquisition premiums were, to some extent, addressed. In Section I.2, the earnings calculation utilizes "common equity applicable to rate base".

This is relevant because under the Division-approved Merger Settlement, acquisition premiums are excluded from rate base.[252] In Docket No. D-00-3, the Division's focus was "to ensure that in any future proceedings where ProvGas' rate of return is at issue there should be a limit on the percentage of common equity which is recognized for rate setting purposes. When calculating ProvGas' weighted cost of capital, any unamortized acquisition premium should be deducted from the common equity measurement in order to properly match the capitalization with the actual utility assets."[253] Clearly, the Division was interested in requiring that any common equity used to pay acquisition premiums be excluded from the capital structure.

Concerns arise when the acquiring corporation utilizes common equity in order to pay for the acquisition premiums to purchase the selling corporation, and the result is a higher common equity ratio for the acquiring corporation. Since common equity is the most expensive component of the utility's rate of return, an increase in the common equity ratio typically increases the rates of customers. The restriction

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[251] Id., pp. 82-83.
[252] Order No. 16338, Division-approved Merger Settlement, p.4.
[253] Order No. 16338, p.53.

on “common equity applicable to rate base” prevents an acquiring corporation such as Southern Union from paying acquisition premiums by issuing more common stock and, thereby causing the ratepayers to pay for the acquisition premiums.

Also, a capital structure with a high percentage of common equity inflated due to acquisition premiums would cause the utility to retain more earnings under any earnings sharing calculation. To prevent this from occurring, the restriction on “common equity applicable to rate base” excludes acquisition premiums from being included in the common equity portion of the capital structure, thereby assuring ratepayers of a greater share of ProvGas’ earnings. Accordingly, acquisition premiums associated with common equity should be excluded from the capital structure.

The ambiguity in the ERI II Settlement Agreement is whether acquisition premiums paid with debt should also be excluded from the capital structure. Section I.2 of the ERI II Settlement Agreement requires the earnings calculations to utilize “the percentage debt in the capital structure.” There is no comparable restriction or reference to debt applicable to rate base, as there is with common equity. However, the Division-approved Merger Settlement states that “acquisition premiums … by a parent company not distort future cost of capital determinations for … ProvGas.”[254] This could be interpreted to mean

[254] Order No. 16338, Division-approved Merger Settlement, p. 10.

that all acquisition premiums should be excluded from the capital structure.

There could be a rational policy basis for distinguishing between acquisition premiums paid through common equity and acquisition premiums paid through debt. The Utah Public Service Commission once declared that "all consequences resulting from the premium payment constitute risks which will be assumed entirely by the shareholders of the Merged Company. No adversities resulting from the premium payment will be considered" for "setting the rate of return".[255] In other words, the special treatment accorded acquisition premiums in public utilities regulation is to protect ratepayers from management's decisions and not to protect management from its own poor decisions.

A capital structure with a high percentage of debt due to acquisition premiums does not harm the ratepayers. Long-term debt is cheaper than common equity. The inclusion of more debt in the capital structure can lower the overall rate of return and the rates charged to customers.

Also, a capital structure with a high percentage of debt will not cause more earnings to be retained by the utility. In fact, it would cause more earnings to be returned to ratepayers. The reason to exclude acquisition premiums from rate base is to ensure that ratepayers do not pay higher utility rates due to the management's decision to pay a

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[255] Re: Utah Power and Light Company, 97 PUR4th 79, 116, (Utah PSC 1988).

purchase price for an asset above its book value. The effect of excluding acquisition premiums from the common equity ratio of a capital structure is to ensure that ratepayers are not deprived of an appropriate share of earnings due to management's decision to pay an acquisition premium. The exclusion from the capital structure of acquisition premiums paid for with debt will not protect or benefit ratepayers; it could only help management.

Interestingly, the Louisiana Public Service Commission recently had to determine how much debt should be included in the utility's capital structure for earnings calculations subsequent to a merger. The Louisiana Public Service Commission interpreted its prior order which incorporated a settlement relating to a merger. The Louisiana Commission determined that the gross proceeds of debt should be included the capital structure rather than the net proceeds of debt as advocated by the utility. The Louisiana Supreme Court upheld the Louisiana Public Service Commission's interpretation even though the utility stated that the commission's interpretation "produces an excess return on equity." The court stated that the utility's position "inflates the percentage of equity capital" but noted that the commission's approach "inflates the percentage of debt capital." The court noted that

equity capital, and it also allows the shareholders with a controlling interest to more easily obtain those assets without diluting their control. The significant danger is that a highly debt-leveraged capital structure magnifies the affects of income fluctuations. If the earnings were to decline due to the economy, competition or the weather, the "consequences are catastrophic" to the enterprise.[257]

Furthermore, the failure of ProvGas to indicate that for purposes of earnings calculations, only debt applicable to rate base would be included, was likely an oversight and omission by the drafter, ProvGas. Under certain circumstances, an omission in a contract can be remedied by a court. Justice Benjamin Cardozo once declared, when addressing whether to rectify an omission, the "transgressor whose default is unintentional and trivial may hope for mercy if he will offer atonement for his wrong".[258] NEGas made an offer of atonement in the form of a Settlement Offer, pursuant to Rule 1.24(b) of $5.227 million and a good faith intent to withdraw NEGas' appeal of a Commission order establishing $500,000 in potential gas procurement penalties. The Commission accepts the Settlement Offer and finds that this Settlement

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a $5.992 million refund and a prospective base rate reduction of $27.159 million. Id. at 894.

[257] Leonard Hyman, America's Electric Industries: Past, present and Future, (3rd Ed. 1988), pp. 73-74, 76-79, 82. The most well known example of a utility enterprise which was highly debt leveraged and collapsed was Samuel Insull's electric holding company empire before the New Deal. Mr. Insull controlled at least half a billion dollars of assets in 1930 with an equity capital investment of approximately $27 million. Its collapse during the Great Depression lead to the enactment of the Public Utility Holding Company Act of 1935. Id. at 74.

[258] Jacob v. Youngs & Kent, 129 N.E. 889 (1921)

Offer approximates $5.885 million and will avoid further litigation and expense in the two dockets. Therefore, the Commission accepts the Settlement Offer as in the public interest and the best interest of the ratepayers.

CONCLUSION

In this proceeding, this Commission had the difficult task of its interpreting its ERI II order and the settlement agreement incorporated therein. Chief Justice Lord Mansfield once declared: "Most of the disputes in the world arise from words".[259] This proceeding was no different. At times the dispute over the meaning of these words became rather contentious, with most of this contention surrounding the phrase "the actual capital structure." Fortunately, this proceeding has caused the Commission to make findings that will enlighten the parties and assist future commissions. As Justice Cardozo once explained, "the sordid controversies of litigants are the stuff out of which great and shining truths will ultimately be shaped."[260]

NEGas makes two dangerous and unsettling arguments regarding the interpretation of this ERI II Settlement Agreement. In regards to adjustments sought by the Division to the ERI II earnings calculations, NEGas argued that there were ambiguities in the ERI II Settlement and that these ambiguities should be construed in favor of NEGas. This approach would allow utilities to deliberately draft settlement

[259] Morgan v. Jones, Lofft 169, 176 (1773).

agreements and tariffs to obscure the meaning of words so that at a later date the same utility can assert the meaning that is most favorable to it. The long standing contract rule that ambiguities are construed against the drafter exists to prevent this situation from arising.[261] Essentially, NEGas' approach would nullify decades of contract law and the public policy underlying this rule. It would have a significant detrimental impact on the public interest and ratepayers in particular. The utility would have a perverse incentive to draft settlement agreements and tariffs in manner that would create ambiguities so as to benefit from these ambiguities at a later date, and as a consequence create immense uncertainty in the regulatory process for establishing just and reasonable rates pursuant to Title 39. This Commission will not reward a utility for either poor draftsmanship or for being a clever wordsmith. This Commission finds that ambiguities in settlement agreements must be construed against the utility, if it is the drafter, to the extent permitted by the public interest.

In regards to the dispute over the meaning of the phrase "the actual capital structure," NEGas' argument is even more far-reaching and audacious. Essentially, its argument is that this Commission, when interpreting its orders and the settlement agreements incorporated into its orders, must interpret these documents in a manner directed by

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[260] Benjamin N. Cardozo, The Nature of the Judicial Process, (1921), p. 35.
[261] Fryzel v. Domestic Credit Corp., 120 R.I. 92, 98 (1978); Contracts, 2nd Restatement, Comment to Section 206.

some of the settling parties, even if it is contrary to the plain language of the agreement. This is a blatant attempt to usurp the Commission's authority under Title 39 to set just and reasonable rates.

Under Title 39, the General Assembly delegated its legislative authority to establish just and reasonable rates to this Commission. The Commission establishes just and reasonable rates in its orders and the accompanying incorporated documents, including settlement agreements. When the Commission issues an order incorporating a settlement, it does not and can not delegate this power to the parties, or even to the Division. The Division and the utility are merely participants in the process known as ratemaking; neither of them has ratemaking authority nor has the Commission ever delegated its ratemaking authority to them. It is the Commission and it alone that establishes just and reasonable rates. In regards to ratemaking, the Division's role is executive in nature, which is to enforce and defend this Commission's orders.[262]

The Commission is also quasi-judicial to the extent that it both establishes these rates through a hearing process and interprets its orders that establish these rates. The Commission, like a court, inherently has the judicial function of interpreting its prior decisions and incorporated settlement agreements. Chief Justice John Marshall once declared that "It is emphatically the province and duty of the

[262] Providence Gas Co. v. Burke, 419 A.2d 263, 268, (R.I. 1980).

judicial department to say what the law is. Those who apply the rule to particular cases, must of necessity expound and interpret that rule."[263] This Commission's power to interpret an order and its incorporated settlement agreement is the power to set just and reasonable rates. Subject to an appellate review by the Rhode Island Supreme Court to ensure that the Commission's interpretation is reasonably based on the law and evidence, the Commission finds that it makes the final determination as to how to interpret its orders and incorporated settlement agreements.

In support of its attempt to dictate the Commission's interpretation of the phrase "the actual capital structure," NEGas made the argument that the intent of two of the four settling parties must be utilized by the Commission, regardless of any other consideration. However, in interpreting a settlement agreement, the Commission is only interested in the objective intent expressed in the document and not some undisclosed, secret understanding. Like a voodoo witch doctor, NEGas has raised the theory of subjective intent from the grave of contract law in support of its position that ProvGas had an actual capital structure during the ERI II period. The subjective theory of contract law disappeared after the Civil War and was part of a larger trend to provide uniformity, certainty, and predictability to the law.[264]

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[263] Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177-178 (1803).
[264] Morton J. Horwitz, The Transformation of American Law: 1780-1860, (1977), pp.197-201.

The objective theory of contract intent was enunciated by Justice Oliver Wendell Holmes when he declared "We ask, not what the man meant, but what those words would mean in the mouth of a normal speaker of English, using them in the circumstances in which they were used."[265] Justice Holmes elaborated on the uncertainty and confusion that would result if the subjective approach of contract interpretation was adopted. Justice Holmes pronounced: "You cannot prove a mere private convention between the two parties to give language a different meaning from its common one…It would open to great risks if evidence was admissible to show that when they said five hundred feet they agreed it should mean one hundred inches, or that Bunker Hill Monument should signify the Old South Church."[266]

This objective intent approach gained momentum into the 20th century. Justice Learned Hand explained that while: "It is quite true that we commonly speak of a contract as a question of intent, and for most purposes it is a convenient paraphrase, accurate enough, but, strictly speaking, untrue. It makes not the least difference whether a promisor actually intends that meaning which the law will impose upon his words. The whole House of Bishops might satisfy us that he had

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[265] Oliver Wendell Holmes, Jr., "The Theory of Legal Interpretation", 12 Harvard Law Review, 417, 417-418 (1899). If there is a single overriding theme in Holmes' writing, it is the necessity of establishing objective rules of law. Morton J. Horwitz, The Transformation of American Law: 1870-1960 (1992), p.110.
[266] Goode v. Riley, 153 Mass. 585, 586 (1891).

intended something else, and it would not make a particle of difference in his obligation."[267]

In 1921, the objective intent approach to contract interpretation was adopted in Rhode Island. The Rhode Island Supreme Court declared "the question being, not what intention existed in the minds of the parties, but what intention is expressed by the language used".[268] Since then, the Rhode Island Supreme Court has consistently declared the objective intent approach is to be applied to contract interpretation.[269] The Rhode Island Supreme Court has declared that the construction placed on the words by the parties themselves is "an aid in determining their intended meaning."[270] An "aid" is not a mandate to interpret words in the manner desired by two of the four settling parties. The Rhode Island Supreme Court has declared that the intent of the agreement is "not some undisclosed intent that may have existed in the minds of the contracting parties."[271] NEGas' approach to contract interpretation regarding the phrase "the actual capital structure" is an attempt to overturn a century's worth of contract law by insisting that the subjective undisclosed intent of some parties can trump the objective intent manifested in the plain words of a document.

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[267] Eustis Mining Co. v. Beer, Sondheimer & Co., 239 F. 976 (S.D.N.Y.1917).
[268] Providence Ice Co. v. Bowers, 44 R.I. 173, 182 (1921).
[269] See e.g. Capital Properties, Inc. v. State, 749 A.2d. 1069, 1081 (R.I. 1999); D.T.P., Inc. v. Red Bridge Properties, 576 A.2d 1377, 1381 (R.I. 1990); W.P. Associates v. Forcier, Inc., 637 A.2d 353, 356 (R.I. 1994).
[270] Woonsocket Teachers Guild v. School Com., 117 R.I. 373, 376 (1976).
[271] Id.

The plain and ordinary meaning as well as the technical meaning of the phrase "actual capital structure" requires an actual corporation. ProvGas was a fictitious business name through which the Southern Union was conducting utility business in Rhode Island during the ERI II time period. A fictitious business name does not have an actual capital structure. The plain ordinary meaning of "actual" is an antonym of "fictitious".

If the subjective intent of the parties trumped all other considerations, including the plain language of the document, it would create immense uncertainty and confusion in contract agreements. The ramifications for agreements affecting the public interest are even more galling. The Commission would be concerned with approving a settlement agreement between parties out of fear that the parties' subjective intent would be imposed upon the Commission and ratepayers. The mythical Pandora's Box would be opened. Justice Holmes once opined that the law is merely "prophecies of what the court will do."[272] When the Commission establishes rates, it engages in a form of prophecy because rates are established prospectively. Although this Commission will, out of necessity, assume the role of prophet, it will not try to play the part of a mind reader by divining the true meaning of the words used by parties. The public interest requires this Commission to reject the subjective intent approach.

To twist the phrase “actual capital structure” to apply to a division, a fictitious business name, creates a Gordian knot, not only for the plain, ordinary, and usual meaning of words, but also for the technical regulatory meaning of these words. To cut through this knot, the Commission had to reject NEGas’ interpretation.[273] The 18th century French philosopher Voltaire once stated that the use of the phrase “Holy Roman Empire” was a misnomer because it was “not holy, not Roman, and not an empire.”[274] A post-merger ProvGas “actual capital structure” would be equally absurd. ProvGas was a fictitious business name with no capital stock and, as a division, was a part of Southern Union’s corporate structure.

NEGas has essentially argued that the meaning of the phrase “actual capital structure” in the ERI II Settlement differs from the meaning assigned to the same phrase in other proceedings. This approach to the meaning of words is reminiscent of Humpty Dumpty. Humpty Dumpty once scornfully told Alice in Wonderland that “When I used a word it means just what I choose it to mean--neither more nor less.”[275] This Commission will not engage in Humpty Dumpty jurisprudence. The phrase “the actual capital structure” in the ERI II

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[272] Oliver Wendell Holmes, Jr., “The Path of the Law”, 10 Harvard Law Review 457 (1897).
[273] Hindson v. Allstate, 694 A.2d 682, 683 (R.I. 1997). In Hindson, Justice Flanders untied the Gordian knot of conflicting primary insurance clauses by applying a pro-rata apportionment of coverage. Id.
[274] Will and Ariel Durant, The Story of Civilization, Volume 11: The Age of Napoleon, (1975), p. 207.
[275] Lewis Carroll, Through the Looking Glass, Chapter 6: Humpty Dumpty.

Settlement means Southern Union. The Commission finds that the plain, ordinary, and usual, as well as the technical regulatory, meaning of words will be utilized over the subjective intent of the parties to a settlement. Ultimately, NEGas could have drafted a document that better reflected its supposed intent.

The Commission was fully prepared to order a large rate reduction by interpreting the ERI II Settlement to mean Southern Union's actual capital structure. The Commission echoes the declaration of Justice Holmes: "Whatever the consequences, we must accept the plain meaning of plain words".[276] NEGas wisely had a Canossa moment and decided to make a Settlement Offer to the Commission of $5.227 million, together with a good faith intent to withdraw its appeal of a recently ordered gas procurement plan containing $500,000 in potential penalties.[277] The compliance filing resulted in a net annual reduction for all ProvGas customers of $948,589, or $19 per year or 1.6 percent for the average ProvGas residential heating customer.

In closing, the Commission states it has followed the law and reviewed the evidence. The most reasonable interpretation of the ERI II Settlement Agreement is to adopt the Division's adjustments and use

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[276] United States v. Brown, 206 U.S. 240, 244 (1907)

[277] The reference to Canossa relates to the town where a historical event occurred in the winter of 1077. At Canossa, Holy Roman Emperor Henry IV went to a castle barefoot and in woolen garments in the middle of winter seeking forgiveness and removal of the ban of excommunication from Pope Gregory VII. This event demonstrated the triumph of the papal authority over secular monarchs during the Middle Ages. Will Durant, The Story of Civilization, Volume 4: The Age of Faith, (1950), pp. 545-551.

the Southern Union actual capital structure as adjusted herein. However, the Commission accepts the NEGas' Settlement Offer because it best serves the public interest and is in the best interest of the ratepayers. The Commission hopes that NEGas' recent regulatory approach of cooperation and recognition of Commission authority, as evidenced by the NEGas Settlement Offer, is real and long-term.

Accordingly, it is

(17524) ORDERED:

1. The Energize Rhode Island Extension Settlement Agreement factor filed on August 1, 2002 by New England Gas Company is denied and dismissed.

2. The system pressure factor of .32 cents per therm filed on August 1, 2002 by New England Gas Company is approved for effect July 1, 2003.

3. The environmental response cost factor of .02 cents per therm filed on August 1, 2002 by New England Gas Company is approved for effect July 1, 2003.

4. The Settlement Offer of New England Gas Company filed on May 22, 2003 is approved.

5. The Energize Rhode Island Extension Settlement Agreement factor of a negative .37 cents per therm and compliance filing submitted June 6, 2003 is approved.

EFFECTIVE JULY 1, 2003, AT WARWICK, RHODE ISLAND PURSUANT TO OPEN MEETINGS ON MAY 22, 2003 AND JUNE 30, 2003. WRITTEN ORDER ISSUED AUGUST 1, 2003.

Elia Germani
Chairman

Kate F. Racine
Commissioner

Brenda K. Gaynor
Commissioner

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May 21, 2003

VIA HAND DELIVERY

Luly Massaro, Commission Clerk
Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

Re: Docket 3459; Distribution Adjustment Clause

Dear Luly:

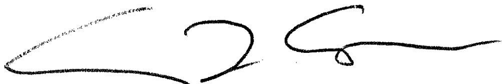
Pursuant to Commission Rule 1.24(b), New England Gas Company ("Company") hereby submits a resolution to the Commission to resolve outstanding issues in the above-referenced docket.

Specifically, the Company will accept the recommendations of the Division of Public Utilities and Carriers (the "Division") as to the "cost-of-service" adjustments that should be made to the earnings sharing calculation under ERI-II Settlement Agreement. The Division's calculation produces "excess" earnings of $3,582,000. In addition, to facilitate the resolution of this case, the Company would agree to calculate ERI-II earnings using the Proxy Capital Structure set forth in the rate settlement in Docket 3401 between the Division and the Company, which was approved by the Commission for the purpose of calculating the Company's earnings going forward.

The combination of the Division's recommendations and the application of the Proxy Capital Structure produces an "excess" earnings calculation of $5,227,000, as set forth in the Division's response to PUC Request 2, issued on April 7, 2003.

The Company would also like to indicate an intent to withdraw its appeal of the Commission's May 1, 2003 order in Docket 3436, which modified the Company's gas purchasing plan guidelines, following a technical session with Commission staff clarifying certain implementation details that were not addressed in the Commission's decision.

Sincerely,



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CLE/kmb
cc: Paul Roberti, Esq.
Mr. Steve Scialabba
Mr. Bruce Oliver

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