STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

PUBLIC UTILITIES COMMISSION

IN RE:	PROVIDENCE GAS COMPANY : “ENERGIZE RHODE ISLAND” : PRICE STABILIZATION PLAN :	DOCKET NO. 2581

REPORT AND ORDER

On August 2, 2000, the Providence Gas Company ("ProvGas" or "Company") filed with the Public Utilities Commission ("Commission") a settlement agreement (“Agreement”)[1] which would extend for a term of twenty-one months, or until June 30, 2002[2], the Energize Rhode Island Price Stabilization Plan (“PSP”) previously approved in Order No. 15448 (issued March 6, 1998). The new Agreement (sometimes referred to herein as the “PSP extension Agreement”) maintains the structure of the PSP and continues benefits enjoyed by ProvGas customers for the past three years, while modifying the PSP to reflect changes in the procurement and cost of natural gas as well as the Company’s cost of service.

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

[2] The new Agreement terminates at the anticipated date of the merger of operations of ProvGas with the operations of Valley Gas and Bristol & Warren Gas Companies. The Southern Union Gas Company has acquired all three companies, and under a settlement approved by the Division of Public Utilities and Carriers, by December 1, 2001 the companies will file a rate consolidation plan for the merged operations for effect on July 1, 2002.

Key elements of the PSP extension Agreement are:

- Base rates are frozen through June 30, 2002, the extended PSP term. The throughput portion of the gas charge is adjusted by 5% to increase distribution system revenues and is then frozen for the extension period, subject only to changes in the liquefied natural gas ("LNG") portion of the charge.

- The Company will receive an increase in distribution revenues of $4.5 million on an annual basis. This increase is in the form of a partial offset to the reduction in fixed gas supply costs. These fixed costs relate to pipeline charges and are reduced by $9 million on an annual basis.

- The commodity portion of the Gas Charge Clause ("GCC") will be reinstated and subject to change as approved by the Commission in Docket No. 1673.

- The Company will waive all claims for recovery of exogenous events under the current PSP for fiscal years 1999 and 2000. The PSP extension Agreement provides for a stricter definition and limitation of exogenous events and costs that can be recovered through the Deferred Revenue Account. Weather-related revenue impacts are excluded from exogenous treatment and will be resolved through a newly developed Weather Mitigation Clause. Also, non-firm margin adjustments will no longer constitute exogenous events.

- The Company will receive an incentive to maximize non-firm margins. Customers will be credited with 75% of all non-firm margins in excess of $1.2 million, and the Company will retain 25% of such margins.

- The Company will expand and improve its distribution system to enhance the safety, reliability and integrity of the system. It commits to replace cast-iron and bare-steel mains and services at an annual rate of seven miles per year (with a "best efforts" goal of ten miles per year). It will also complete the replacement of its paper-file system for mapping mains and services with an Automated Mapping and Facilities Management ("AM/FM") system. Finally, subject to regulatory approvals, it will provide additional capacity on Aquidneck Island.

- The Low-Income Heating Assistance Plan ("LIHEAP") will be funded through the extended PSP term at an annual level of $1.3 million. This is an increase of $300,000 over the current funding level. The Low-Income Weatherization Program will be funded at an annual level of $300,000 in the first year and $200,000 in the second year. In addition, the Demand-Side Management ("DSM") rebate program will be funded at a rate of $300,000 per year.

- Agreements regarding the accounting treatment of costs associated with the evaluation, remediation and clean-up related to the Company's ownership or operation of manufactured gas plants, mercury regulators and meter disposal ("Environmental Response Costs"), as well as the amortization of Year 2000 costs, and the treatment and amortization of the unamortized balance of the Company's Legacy Customer Information System ("CIS").

- At the end of the PSP extension period, an earnings report will be filed with the Commission, calculating the Company's return on equity ("ROE"). Earnings in excess of 10.9% ROE will be refunded to customers; any shortfall if the ROE falls below 7% will be collected from customers. The agreement also places certain limitations on the Company's capital structure and O&M expenses.

- The Company will develop the Weather Mitigation Clause and a plan to revise rates on a revenue-neutral basis in order to implement therm billing, and file these with the Commission within thirty days.[3]

A technical record conference on the filing was held on August 21, 2000 at the offices of the Commission, 100 Orange Street, Providence, RI. The following appearances were entered:

FOR THE COMPANY:	John Partridge, Esq. Dennis J. Duffy, Esq.
FOR THE DIVISION:	Paul J. Roberti Assistant Attorney General

[3] On September 21, 2000, the Company filed an Amendment (Joint Exhibit 2) to Settlement Agreement, a copy of which is attached hereto and incorporated by reference as Appendix B. The Amendment contained the newly-developed Weather Mitigation Clause promised in the Agreement. However, the Amendment withdrew the therm billing proposal, indicating that implementation thereof would be postponed until the rate consolidation plan becomes effective at the end of the PSP extension period. See also T. 9/22/2000, p. 28.

FOR THE COMMISSION: Adrienne G. Southgate
General Counsel

The purpose of the conference was to have the settling parties – the Company, the Division of Public Utilities and Carriers ("Division"), the Energy Council of Rhode Island ("TEC-RI") and the George Wiley Center – explain in detail the changes to the current PSP contained in the PSP extension Agreement.

Following notice, hearings for the purpose of receiving public comment on the Agreement were conducted on September 6 and September 21, 2000.[4]

The evidentiary hearing on the Agreement was conducted at the Commission's offices on September 22, 2000 at 10:00 A.M. The parties were represented as previously identified. Public comment was provided by Michael A. Snitzer, the Weatherization Assistance Program Manager from the State Energy Office, who fully supported the extension of the Energize Rhode Island plan. Mr. Snitzer added that ProvGas is the only utility currently involved in direct weatherization; in the past four years, approximately 400 homes have

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[4] Those testifying included Peggy O'Neill; Shirley Vacher, a worker with the Campaign to Eliminate Childhood Poverty; Alma Roias; Maria Lascimento; Monica Richards; Richard Neilan of the Gray Panthers; Charles Pinning; Nancy James; Richard Bidwell of the Gray Panthers; William Gilmore, Facilities Engineer at Bryant College and member of the Collaborative for Demand-Side Management and Renewable Energy Resources, a signatory to the Agreement; Barbara Gobern, President of St. Vincent de Paul Church in East Providence; and Henry Shelton, coordinator of the George Wiley Center.

been weatherized with ProvGas funds.[5] The program returns $2.39 for every dollar invested.[6]

Additional public comments were received from Christina Soto of the Campaign to Eliminate Childhood Poverty, and Henry Shelton.

The Company called James DeMetro, Executive Vice President of ProvGas to testify in support of the Agreement.[7] Mr. DeMetro began by clarifying certain points raised during the technical record conference on August 21st. In particular, he noted that ProvGas now includes the LIHEAP eligibility guidelines in customer bills, so that all customers can be alerted to the low-income heating assistance qualification requirements. He added that the Company participates in the Good Neighbor Energy Fund, and will be taking part in numerous community fairs over the year in order to disseminate information. Further, information about low-income assistance programs will be posted on the Company's website, and utility employees will be educated to act as "ambassadors" for the programs.[8]

With respect to federal LIHEAP funds, Mr. DeMetro testified that ProvGas, together with the New England Council of Energy, has met with the New England congressional delegation to request support for additional LIHEAP

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[5] T. 9/22/2000, p. 7.

[6] Ibid., p. 9.

[7] Mr. DeMetro's prefiled testimony and schedules accompanying the Settlement Agreement were admitted as Joint Ex.1.

[8] T. 9/22/2000, p. 25.

funding. In this regard, letters have been sent to the President of the United States and to the U.S. Secretary of Energy requesting increases in LIHEAP funding.[9]

In order to assist customers in paying their bills, the Company has distributed new billing inserts describing the Company's Budget Plan, and included both a telephone number sign-up and a mailer to facilitate customer enrollment in the plan. Finally, the Company has agreed to increase the delinquent balance threshold for utility service termination from $375.00 to $500.00.[10]

Mr. DeMetro commented that the Agreement is designed to stabilize and control two significant elements of customer bills that are most within the utility's control. On a net basis, distribution costs and pipeline costs are reduced by approximately $6 million over the twenty-one month period of the PSP extension Agreement. The balance of the bill, representing commodity costs, will be addressed in the context of the Company's GCC filing in Docket No. 1673 in which the Company will propose a hedging program designed to manage price volatility.[11]

During cross-examination, Mr. DeMetro explained that the fixed-cost reduction of approximately $9 million annually, or roughly 30%, has been made possible through the renegotiation of the Company's contract with Duke Energy,

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9 Id.

10 Ibid., p. 26.

subject to regulatory approvals.[12] This reduction in fixed pipeline costs was accomplished by altering or canceling certain pipeline supply arrangements over the past three years. The major change was a significant reduction in the Tennessee pipeline supply contract effective October 2000.

Mr. DeMetro stated that during the fall of 1999, the Company explored with Duke Energy the possibility of fixing commodity prices for an extended period of time as well. The Company elected not to proceed, Mr. DeMetro testified, both because commodity prices were relatively high (14% to 23% higher than then-current PSP pricing) and were forecast to decline, and because of the premium which would have been assessed owing to the volatility of prices over the previous period.[13] He also testified that under its new contract with Duke Energy, the Company could secure commodity supplies at a cost equal to the NYMEX price plus variable costs and fuel charges.

Mr. DeMetro also testified that ProvGas has secured fixed pricing for roughly 5% of its annual supply, excluding storage.[14] In contrast, during the prior three years, the Company had secured its entire commodity supply at a single fixed price under its agreement with Duke Energy.

Mr. DeMetro next discussed the treatment of non-firm margins. The Company also called as additional witnesses Timothy Lyons, Director of Rates,

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[11] Ibid., pp. 29-30.

[12] Ibid., pp. 33-34.

[13] Ibid., pp. 37-38.

[14] Ibid., p. 40.

and Kenneth Hogan, Senior Vice President for Finance and Administration. Mr. DeMetro explained that, prior to the PSP extension Agreement, the Company's firm ratepayers were responsible for an imputed revenue stream from non-firm margins, since an assumed revenue level was imputed in calculating (i.e.,— lowering) the Company's firm rates. This level of margins recoverable from ratepayers amounted to a rolling three-year average of actual non-firm margins. In the first year of the current PSP (i.e., fiscal year 1998), the Company recovered a shortfall in non-firm margins of approximately $900,000 from ratepayers as an exogenous cost.

The PSP extension Agreement removes non-firm margins from exogenous cost consideration. Instead, the Company is allowed to retain the initial $1.2 million of non-firm margins and, as an incentive, to retain 25% of any non-firm margins in excess of $1.2 million. Ratepayers, in turn, will receive 75% of any non-firm margins in excess of $1.2 million. Under the Agreement, however, the 25% incentive will not count in determining Company's earnings under the earnings cap.

Mr. Lyons explained the development of the new Weather Normalization Clause ("WMC"), its interaction with the Company's existing block rate design, and how the dollar compensation for degree-day variation was selected.[15] When questioned by the Commission about some American Gas Association literature concerning weather mitigation clauses, Mr. DeMetro indicated that the instant

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[15] See, generally, ibid., pp. 54-60.

proposal was basically a "Type 2" clause which defers weather impact adjustments for recovery in future periods. He noted that through the course of the PSP extension period the Company and the Division would be meeting to resolve issues and determine whether to postpone a true-up of deferred amounts, or to immediately implement a refund to customers or credit to the utility, as appropriate.[16] The Commission also requested the Division's views on this point, and Bruce R. Oliver, the Division's consultant, responded that there had been several reasons to reject the "Type 1" clause (real-time adjustment to bills) in favor of a seasonal adjustment mechanism.[17] Mr. Oliver concluded that the proposed WMC provides ProvGas "with protection against large variations in revenues as a result of weather impact without an expensive complicated process while also providing a fair opportunity for ratepayers to enjoy the benefits of some credits back if weather is colder than normal."[18]

The WMC (subsequently filed as part of Joint Exhibit 2) provides for an adjustment to the Deferred Revenue Account ("DRA") if the actual degree days vary from normal by plus or minus 2%. Colder than normal weather will produce a credit for ratepayers to the DRA, while warmer than normal weather will produce an amount owing to the Company to be charged to the DRA. The weather variation will only be measured for the period November through April. For this six-month period, the DRA will be credited or charged in the amount of

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[16] Ibid., pp. 64-65.

[17] Ibid., p. 68.

$7,800 for each degree day over 5,055 or under 4,857. Mr. Lyons testified that the $7,800 was determined by the Company to represent a reasonable margin for the weather impact for the November through April period. He noted that this compensatory amount was supported by detailed calculations on rate class impacts due to weather variations, and that the variation amount will also affect how much the Company may have to pay to ratepayers if weather is colder than normal.[19]

There were also queries by the Commission about the unamortized balance of the Legacy CIS system taken out of service in 1999. The Agreement allows the remaining unamortized balance of the Legacy system costs to be recovered in rates as part of the Company's Y2K expenses; however, this balance will not be reflected in the Company's rate base. Mr. Hogan indicated that the unamortized Y2K costs would be part of the rate consolidation filing required to be made prior the conclusion of the extended PSP period, but the that the unamortized costs of the Legacy CIS system would be excluded.[20] Also, Mr. Hogan outlined the treatment of environmental remediation costs, stating that the Company would include actual cash expenditures for environmental remediation costs in the rate base (depending upon whether the balance was an

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18 Ibid., p. 69.

19 Ibid., pp. 57-58.

20 Ibid., p. 82.

asset or a liability account), but not any accruals for costs that have not yet been paid.[21]

Mr. Hogan testified that he had originally estimated $10 million for the environmental remediation at Allens Avenue in fiscal year 2000. However, this figure had been updated since the original data response. The Company now expects to incur about $5.8 million in 2000 and $8.5 million in 2001.[22] Mr. Hogan stated that the estimate for 2001 is a "worst case scenario," and he felt a reasonable estimate might be in the order of $3.5 million.[23]

During the hearing, an issue arose regarding the amortization of the balance of the Company's Y2K costs. The total costs incurred for Y2K expenses were $7.7 million. The Company is amortizing only $600,000 of those costs this year. However, the PSP currently in place requires a five-year amortization, which would result in a higher annual amortization amount. Asked to explain why so little was being amortized this year, Mr. Hogan responded that the existing PSP has an allowed balance that was treated as a cap for the amortization calculation; the proposed PSP simply adopts that sum and recalculates the amortization thereof over a fifteen-year period.[24]

On behalf of the Division, consultant David J. Effron was sworn to testify on the Y2K amortization issue. He disagreed with the Company's interpretation

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[21] bid., pp. 82-83.

[22] Ibid., p. 86.

[23] Ibid., pp. 87-89.

[24] Ibid., p. 90.

of the Y2K amortization provision of the current PSP, stating, "[A]mortization in any given year would be based on the amount that had been deferred without reference to what the estimates were or what any possible cap might be. The costs would be deferred as incurred and then amortized over five years subsequently."[25] After conferring with Division counsel and staff, Mr. Effron subsequently testified, "I believe that the unamortized Y2K balance existing at the end of fiscal year 2000 would be somewhat less than the Company has reflected in the responses to some of the information requests."[26] In response to a record request of the Commission, the Division submitted a recommended Y2K balance at September 30, 2000 of $5,398,000, requiring an adjustment of $1.4 million to the balance filed by the Company in this docket.[27]

In July 1999, the company installed a new data processing system, the Banner CIS system, which replaced the former Legacy customer information system.[28] The Banner system is to be amortized over eighteen years.[29] The former Legacy system, which was put into service in 1991, was not Y2K compliant.[30] The Legacy system was to have been amortized over ten years, but

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[25] Ibid., p. 93.

[26] Ibid., p. 163.

[27] Joint Ex.1, Schedule 3, p. 29a.

[28] Ibid., p. 94.

[29] Ibid., p. 96.

[30] Ibid., p. 95.

was retired after eight years; the unamortized amount would be rolled forward for recovery as part of the Y2K costs, with a proposed fifteen-year amortization.[31]

Mr. Hogan said the long amortization period for the Banner system was designed to keep costs low,[32] and to reflect the fact that the bulk of the costs related to data conversion required in moving from the Legacy system to the Banner system.[33] The Banner system is widely used by utility companies.

During cross-examination, it was noted that the Company's cash working capital requirement had changed significantly in the earnings calculation performed on a prospective basis under the Agreement.[34] Mr. Hogan noted that the Company had utilized the most recent calculation of the lag days for revenue collections under the methodology agreed to in Docket No. 2286.[35] He asserted that this was legitimate because the Agreement states that the Company will use the methodology set forth in Docket No. 2286, rather than the actual lag days determination established by the Commission in that docket.[36] However,

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31 Id.

32 Ibid., pp. 96-97.

33 Ibid., p. 100. Mr. Hogan testified that of the $12 million in Banner system costs, the operating system (software) represented about $800,000; data conversion and system testing were $9.3 million; and Company labor associated with data conversion was about $2 million.

34 Ibid., pp. 121, 123; see also Response to Commission Data Request 1-9.

35 This number was updated to 68.22 days in response to Commission Data Request 2-4. The actual number of lag days approved in Docket No. 2286 was 53 days.

36 T. 9/22/00, p. 124.

Mr. Hogan conceded that the Company was "not sure what the current lag is" and was using a figure from 1994-1995.[37] Asked when the Company would be performing a lead/lag study to determine the appropriate working capital requirement for the PSP extension period, Mr. Hogan responded that this could be done "with the first report that we file with the Commission because we now have in the customer information system 12 months of good payment history [since the Banner system was installed] in July of 1999."[38] For the Division, Mr. Effron concurred that the intention of the settlement was to have the Company adopt approved methods and practices, using the latest available data.[39]

On behalf of the Division, both Mr. Effron[40] and Mr. Oliver[41] submitted prefiled testimony in support of the PSP extension Agreement. They were asked to explain why the Agreement is an appropriate bridge for ratepayers until a general rate consolidation filing amalgamating ProvGas, Valley Gas and Bristol & Warren Gas Companies, now operating as separate divisions of the Southern Union Gas Company, is implemented at the end of the PSP extension period. Mr. Oliver cited the need for a transition period, because consolidating the operations of ProvGas with those of Valley Gas and Bristol & Warren Gas Companies will require a much more comprehensive examination of costs and

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[37] Ibid., p. 128.

[38] Ibid., p. 126.

[39] Ibid., p. 127.

[40] See Division Ex. 1.

[41] See Division Ex. 2.

ratemaking.[42] The Companies are not presently ready to pursue such a rate case to reflect a consolidation of operations, but since the current PSP program will terminate on October 1, 2000, an alternative needs to be put in place. Mr. Oliver expressed concern that while the PSP extension Agreement provides base rate stability, it does not provide price stability. However, the Agreement reasonably recognizes cost changes in both fixed costs and base rates that have occurred since the inception of the PSP in 1997, provides for the resolution of exogenous claims, and allows the Company to maintain its financial health while providing reliable service to its customers.[43] Mr. Oliver stated that the Agreement was in the best interests of the ratepayers.[44]

Mr. Effron testified on the rate impacts of the Agreement. In his prefiled testimony, Mr. Effron noted that the Division's review in this docket consisted of eight sets of data requests propounded to the Company,[45] as well as other direct inquiries made to the Company. He concluded that, having compared the revenue increase authorized in the Agreement to the projected revenue deficiency during the PSP extension, the rate impacts upon customers are very reasonable.[46]

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42 T. 9/22/00, p. 159.

43 Ibid., p. 160.

44 Ibid., p. 161.

45 The eight sets of data requests were entered into the record as Division Exhibit 3; T.9/22/00, p. 152.

46 Ibid., pp. 161-162.

The Commissioners considered the PSP extension Agreement at an open meeting conducted on September 29, 2000. They agreed that the new PSP provides substantial benefits for ratepayers, with the non-commodity portion of rates frozen, additional low-income assistance provided, and the inclusion of DSM.

However, the Commissioners expressed concern about the Company's lack of gas purchases for the upcoming winter season. The Company has entered into another agreement with Duke Energy which sets a fixed price for pipeline costs for the next two winter periods. Although this new Duke Energy agreement also allows the Company to lock in *commodity* purchases at a fixed price, the Company has not moved on securing any significant commodity supplies for the upcoming winter season. The Commission generally felt that this exposes the ratepayers to market risks that have been better managed under the current PSP's provision of a fixed commodity price. Furthermore, the Commission expressed concern regarding the prudency of the Company's gas supply management given the fact that the current PSP would be expiring at the end of September.[47] As a result, the option was proposed of reducing the allowed return on equity ("ROE") specified in the PSP extension Agreement from 10.9% to 10.7% to reflect the Commission's dissatisfaction with the utility's gas supply

[47] The Commission is undertaking a review of the prudency of the gas supply management and procurement activities of ProvGas, Valley Gas and Bristol & Warren Gas for the winter 2000-01 period in Docket Nos. 1673 and 1736.

management with respect to the period following the expiration of the current PSP.

The Commission was also concerned with the Company's treatment of Y2K costs under the PSP extension Agreement. The current PSP specifies a five-year amortization period for these costs. However, the Company has amortized approximately $1.4 million less than what the current PSP requires. The Commission addressed the accounting for these costs by proposing in a motion that the unamortized Y2K balance proposed by the Company be adjusted downward by $1.4 million to approximately $5.4 million.

The Commission also addressed three other matters relating to significant costs being incurred by the Company: (1) environmental remediation costs approaching $20 million that have significantly exceeded cost projections made in the initial PSP; (2) the Company's $12.7 million investment in a new CIS system (the 'Banner System'); and (3) a working capital allowance that differs significantly from the Commission's determination in a prior docket. In regard to the environmental costs and the Banner system, the Commission noted that the Division and Commission have not had the opportunity to fully examine the costs recorded and therefore, have reserved the right to further review such costs and their amortization periods in the next rate proceeding or in a separate docket. Regarding the working capital allowance, since the record does not contain a current lead/lag analysis and the Company has agreed to perform such an analysis, the Commission will reserve the right for the Division, other parties and the Commission to review a current working capital calculation when it is completed by the Company.

After considering the evidence and balancing the ratepayers' needs with the Company's interests, the Commission unanimously approved a motion to approve the PSP extension Agreement, provided that it is modified to:

- reduce the allowed ROE to 10.7%;
- adjust the Y2K unamortized balance downward by $1.4 million to $5.4 million;
- leave the working capital allowance unchanged until further Commission review; and
- reserve the right of the parties and the Commission to revisit the costs and appropriate accounting for the Banner system and environmental remediation in a future proceeding.

In response to the Commission's findings, the settling parties filed a Second Amendment to the Agreement on October 4, 2000, incorporating the modifications requested by the Commission at its September 29th open meeting.[48]

Accordingly, it is

(16584) ORDERED that:

The Providence Gas Company's "Energize Rhode Island" Price Stabilization Plan shall be extended through June 30, 2002, in accordance with the terms of the Settlement Agreement filed on August 2, 2000 and the Amendment thereto filed on September 21, 2000, as further amended by the Commission's open meeting decision on September 29, 2000 and ratified by the Second Amendment to Settlement Agreement filed on October 4, 2000.

EFFECTIVE AT PROVIDENCE, RHODE ISLAND ON OCTOBER 1, 2000, PURSUANT TO AN OPEN MEETING DECISION ON SEPTEMBER 29, 2000. WRITTEN ORDER ISSUED APRIL 30, 2001.

PUBLIC UTILITIES COMMISSION

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Elia Germani, Chairman

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Kate F. Racine, Commissioner

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Brenda K. Gaynor, Commissioner

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[48] A copy of the Second Amendment to Settlement Agreement is attached hereto and incorporated by reference as <u>Appendix C</u>.