Chairman's Memo for Discussion at Open Meeting

Date: August 30, 2022
Subject: Docket 5210, Rhode Island Energy's FY 2023 Gas ISR: Application of Used and Useful Standard to Leak-Prone Pipe Projects

Background: An Overview of the Current ISR Ratemaking Process

In 2010, the Rhode Island General Assembly enacted a new law which mandated that all gas distribution companies file with the Commission an annual infrastructure, safety, and reliability spending plan.[1] The Commission refers to this annual plan as the "Infrastructure, Safety, and Reliability" plan," or "ISR." The ISR plan provides a capital investment plan that is designed to ensure the safety and reliability of the gas distribution system through a number of investment programs or initiatives. One is the proactive main replacement program which is aimed at replacing leak-prone gas mains. Replacing leak-prone pipes is the largest component of the investment plan. It addresses safety concerns relating to the dangers of gas leaks, and it reduces costs to ratepayers because the cost of fugitive gas lost to the atmosphere is indirectly funded by ratepayers in the cost of procuring gas supply. Equally important, there is an environmental benefit by preventing the emissions of methane into the atmosphere, which is a harmful greenhouse gas.

Under well-settled ratemaking rules, the utility is compensated for investment in capital projects when such projects are placed into "rate base," upon which the utility earns a return, recovers depreciation expenses over the life of the asset classifications, and is reimbursed for applicable tax effects. It is the rate base treatment of the capital costs which commences utility cost recovery for the capital investments made by shareholders of the utility.

Prior to the passage of the law which created the ISR, the utility could not commence recovery of the costs of its capital projects until it filed a general rate case and the Commission allowed the costs in rate base after the statutory nine-month review process was completed. This created a regulatory lag in cost recovery. The ISR process is a statutory modification of the traditional rate case process, which had been the exclusive regulatory means through which the utility could commence recovery of its costs of investing in capital projects, among recovery of other business expenses. The ISR eliminated the regulatory lag on recovery of the costs for certain prioritized investments, allowing current and annual recovery of the capital costs of projects eligible for rate base treatment in each year.[2] While the ISR recovery requires ratepayers

[1] R.I. Gen. Laws § 39-1-27.7(c)(2). The law also requires an annual reconciliation of costs to revenues.
[2] Because there is uncertainty of when each capital project will actually be completed in the applicable year, there is a "half-year convention" which is used to allow commencement of rate base treatment for the total estimated capital projects that are forecasted to be completed in the applicable rate year. This is a means of allowing the average of

to begin paying for the costs sooner, it also provides an important financial incentive for the utility to invest in new plant that is needed for reliable and safe service. A regulatory check on overspending is built into the process whereby the Company must negotiate an investment plan with the Division and such plan is filed with the Commission for approval.

Once a main replacement project is completed, the utility is allowed to include the total capital cost of the project in the ISR rate base, which commences recovery in rates from ratepayers of return on investment, depreciation, and taxes. The capital cost also includes an allowance that addresses the time value of money, referred to as an "Allowance for Funds Used During Construction" (AFUDC). The AFUDC rate is effectively an interest rate that is applied to the total accumulating project cost until the project is completed.[3] It is a standard convention of ratemaking which allows the utility to be compensated for the cost of capital while the project is pending and before it is eligible for rate base treatment. AFUDC accumulates on the Company's books. When the final capital cost of the project is included in rate base, the accumulated AFUDC is added to that total cost. Thus, the AFUDC component becomes a part of the capital cost upon which the utility earns a return and is depreciated over the designated life of the asset through depreciation expenses that are recovered from ratepayers.

The main replacement program, of course, results in a new main being placed into service and the old leak-prone pipe being taken out of service and abandoned. In the case of replacements of leak-prone pipes, the old main to be abandoned typically has service connections to customer premises. Thus, an important step in the construction sequence of the project – before the old main can be abandoned – is to transfer or replace each service connection. In each instance, the service connection is removed from the old main and a connection is made to the new main. These customer service connections must be undertaken one connection at a time, after the new main is gassed in. However, this transfer of services takes place while the old main is still providing service and is fully pressurized. During this time, both the new main and the old main have gas flowing at the same pressure.

The ISR process addresses the annual plan for these main replacements, but the Commission has applied traditional ratemaking principles to determine the annual revenue requirement. The initial decision to make an investment to replace leak-prone pipes in a given project is pre-approved by the Commission in the ISR process after being reviewed by the Division. However, there is always a prudency risk for the utility relating to cost over-runs associated with the execution of any utility capital project. In addition to cost over-runs, there also is a prudency risk related to project execution which encompasses the potential that an unreasonable delay in completing a project might unnecessarily extend the period of time upon which the utility would accumulate AFUDC on the capital being expended for the project. In cases where there is evidence that a delay was a result of imprudent management, the

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projects to commence rate base treatment, but the costs tied to actual in service dates is later reconciled in a later filing.

[3] The current AFUDC rate is 7.41%. Hr'g Tr. at 99 (Jun. 1, 2022). Response to Record Request No. 21 (Jun.29, 2022).

Commission has the authority to disallow a portion of the accumulation of AFUDC related to the period of delay.[4] In such case, cost recovery for the investment and the accumulation of AFUDC prior to the delay would be includable in rate base, but there would be a disallowance for the incremental accumulation of AFUDC pertaining to the delay period.

The Timing of Rate Base Treatment:
Applying the Used and Useful Standard with the "Act on Climate" in View

In this case, questions arose about delays that occurred in the abandonment of leak-prone pipes in the main replacement program after new mains were gassed in during fiscal years 2021 and 2022.[5] According to the Company, the delays were attributable to the challenges the utility faced relating to the COVID pandemic – particularly in how it affected changing out service connections for individual customers – among other effects. The Division concurred with the Company's claim that the delays were reasonable under the circumstances. Based on the evidence, I believe it is reasonable for the Commission to accept the prudency of the management of the main replacement projects that were undertaken in fiscal years 2021 and 2022, even though the pace of abandonments fell well beyond the pace of new main installations.

In reviewing the evidence of what transpired during these two fiscal years, however, it became clear to me that the utility has no financial incentive to abandon the old main once the new main has its first service connection. This is because the total project cost is included in rate base before the old main is actually abandoned. Specifically, when the first service connection is made, the Company has historically treated the new main as being "in service" for purposes of including the total project costs in the ISR rate base calculation for ratemaking purposes.[6] Once the project is included in ISR rate base for ratemaking purposes, the delay in abandonment has no negative financial implications for the utility because the Company earns a return on the total investment and commences the recovery of depreciation expenses.

This review has given rise to the question whether the Commission should reconsider how we treat the new main for ratemaking purposes when the old leak-prone pipe which the new main is replacing remains in service. This question relates to the ratemaking principle referred to as the "used and useful" standard.

As the Rhode Island Supreme Court has described the ratemaking principle:

> "We have defined 'rate base' as 'the utility's total investment in, or the fair market value of, the used and useful property necessarily devoted to the rendering of regulated service.

[4] *See Providence Gas Company v. Malachowski*, 600 A.2d 711, 716-17 (R.I. 1991)(Facts were insufficient to support disallowing AFUDC, but authority to disallow is clear if evidence supports finding.)
[5] The fiscal years ran from April 1, 2020 through March 31, 2021 (FY 2021) and April 1, 2021 through March 31, 2022 (FY 2022).
[6] Hr'g Tr. at 91 (Jun. 1, 2022).

> . . . The elements of the value may be either tangible or intangible but the traditional test is whether the questioned property is 'used and useful.' A horse and buggy might conceivably be used in a modern facility, but it may not be very useful because of other modern-day modes of transportation. On the other hand, property ordered and purchased but for other reasons not placed into service might be useful but not used."[7]

The Company's main witness testifying about the projects stated that the risks of leaks on the yet-to-be abandoned old pipe remain the same, even though the new main is connected to the system. In other words, the leakage risks which the main replacement program is designed to address remain unchanged until the old pipe is actually abandoned.[8] In the case of the leak-prone main replacement program, all safety issues associated with the old main continue and methane leaks still occur at the same rate because the pressure in the old main remains at the same level as the pressure in the new main while the old main remains in service.[9] The purpose of the new main is to abandon the leak-prone pipe for safety and environmental reasons. Yet, as long as the old main remains in service, this critical purpose has not been achieved. While the old main remains in service, the new main merely mirrors the service that was being provided by the old main until all the old services are moved to the new main and the old main is shut off and abandoned. In fact, the Company's own "key performance indicator" for measuring performance of the employees charged with completing the main replacement projects is based on the abandonment.[10] In the words of the Company's witness, the abandonment is the "culmination of the project in many ways."[11]

Consistent with the manner in which the Company manages and tracks the projects, I have concluded that it is important to consider the main replacement project as one project consisting of construction of the new main and abandonment of the old main. In fact, the Company's current practice is to add the costs incurred during the service connection and abandonment process to the original capital cost of the project that goes into rate base in the next year's reconciliation.[12]

The importance of assuring that the old main is abandoned within a reasonable period of time is now even more critical given the recently passed Act on Climate, which establishes enforceable targets for the reduction of greenhouse gas emissions and reflects a policy that prioritizes the reduction of greenhouse gases into the atmosphere.[13] One of the key objectives of the main replacement program is to eliminate the risk of methane being released into the

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[7] *Newport Electric, v. Public Utilities Commission*, 624 A.2d 1098, 1101 (R.I. 1993)(citations omitted).
[8] Hr'g Tr. at 47-49 (Mar, 15, 2022). ("CHAIRMAN: Until the old main is replaced the risk of leaks on the yet-to-be abandoned main remain at the same level of risk that we had prior to putting in the new pipe next to it? MS. SMITH: The risks associated with leaks on those segments of mains would remain, yes."); *see also* Docket No. 5165 Hr'g Tr. at 33-38 (Oct. 13, 2021).
[9] Docket No. 5165, Hr'g Tr. at 34-35 (Oct. 13, 2021).
[10] Hr'g Tr. at 71-72 (Jun. 1, 2022).
[11] Hr'g Tr. at 71 (Jun. 1, 2022)
[12] Hr'g Tr. at 105 (Jun. 1, 2022)
[13] R.I. Gen. Laws § 42-6.2-9.

environment from the leak-prone pipes targeted for replacement. This objective is not met by the installation of the new main unless and until the old leak-prone pipe is replaced.

During the evidentiary hearings, the Commission asked the Company and the Division to respond to a two-part straw proposal to change the ratemaking parameters for the main replacement program.[14] The Commission specifically asked the following:

> Given the high degree of importance that the Act on Climate places on reducing greenhouse gas emissions, please provide comment on the reasonableness of the Commission adopting a revised ratemaking rule for the Gas ISR for the purpose of incentivizing the Company to complete each project all the way through to abandonment of the old leak-prone main. The proposal would have two parameters:
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> (i) New gas mains under the Company's main replacement program would not be considered to be "in-service" for ratemaking purposes until the old main with which the new replacement main is associated is abandoned; and
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> (ii) The Company would be directed to stop the charging of AFUDC as of the date that the Company connects the first customer to the new main or, if it is a gas main that would not be expected to have any service connections, the date the main is "gassed in."

Unfortunately, the Company did not make any attempt to address the Act on Climate, other than making a legal argument that the Act on Climate did not contain any provisions to override Rhode Island Supreme Court precedent with respect to the "used and useful" standard.[15] The Company missed the point. The straw proposal was not proposing to override the used and useful standard. Rather, the straw proposal was proposing to apply the used and useful standard based on a finding that the installation of the new main and the abandonment of the old constitutes one project that is not completed until the old main is abandoned. From my perspective, given the policy objectives of the Act on Climate, it is no longer reasonable to treat the new main as being "useful" until the methane leaks have been completely eliminated by abandoning the old pipe. For that reason, the Company's response was neither relevant nor helpful.

The Company also argued that once newly installed mains are gassed in, they are being devoted to regulated service and, thus, considered used and useful for purposes of including the main in rate base. But the Company's view is too simplistic and ignores the principle that a capital project needs to be providing net benefits to ratepayers. This is not a new concept in rate regulation. As stated by a court in neighboring jurisdiction: "The 'used and useful' standard generally requires that a utility plant must be in commercial operation and providing net benefits to customers in order for expenses associated with it to be included in rate base."[16] There also has been scholarly commentary that has emphasized the importance of a capital project

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[14] Record Request 23.

[15] Response to Record Request 23 at 4.

[16] *Town of Hingham v. Dept. of Telecommunications and Energy*, 740 N.E.2d 984, 989 (Mass. 2001).

providing benefits in order to be given rate base treatment under the used and useful standard.[17] In the instance where the primary benefit being targeted is safety and leak reduction, the installation of the new main produces none of these critical benefits until the old main is abandoned, even though it is providing service connections in sequence to individual customers transitioning from the old to the new.[18]

Further, it has been noted that in order for a project to be considered "used and useful," it not only must be "devoted to providing utility service," but also must be "reasonably necessary to the provision of utility service."[19] The Commission has discretion in applying this standard. While the main replacement project needs to be sequenced to transfer the services over to reach project completion, the new main is not technically necessary to serve customers as long as the old main remains in service in a duplicative manner. Stated simply, the project is not complete and providing the critical targeted benefits for ratepayers until the moment occurs when all the transfers have been made and the old main is finally abandoned.

It is important to note that we have a considerable amount of discretion when applying ratemaking methods to the decisions we make. As the Supreme Court has stated, "when reviewing a decision of the commission, our concern is not with the method used to attain a particular result but with the fairness and reasonableness of the end result itself. . . . Indeed, keeping in mind the determination of what is fair and reasonable requires a balancing of investor and consumer interests."[20] What I am proposing is very fair to both the utility that will still recover its costs, and to the ratepayers who are funding those costs and expecting the leaks to be addressed within a reasonable time as a result of the expenditures. Further, it is apparent from the review of sources, that the "used and useful" standard has been interpreted and applied in different nuanced ways across various jurisdictions and is "not constitutionally mandated."[21]

The Company also made a passing reference to the Federal Energy Regulatory Accounting Regulations, stating that its current way of applying the used and useful standard "is consistent with" those rules.[22] But this bare statement of consistency asserts nothing binding about the way they have historically applied the ratemaking rule as an accounting convention. Whether an asset is "used and useful" is a factual determination by the regulatory authority

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[17] *See* Baumol, W., "The Pig in the Python: Is Lumpy Capacity Investment Used and Useful?", 23 *Energy L.J.* 383, 385-386 (2002); Hoecker, J., "'Used and Useful': Autopsy of a Ratemaking Policy," *Energy L.J.* 303, 312 (1987). It is important to note that the case of main replacement of leak-prone pipe is not a case of installing excess capacity for a targeted forecasted need to avoid capacity shortages which is economically beneficial when installed, it is a case of main installation projects not yet completed to meet the targeted purpose.

[18] Arguably, the utility could seek to put into rate base the cost of each individual service connection, but the amounts are likely to be so small that the administrative burden of tracking those costs may not justify it.

[19] "'Used and Useful' Rule," 73B *C.J.S. Public Utilities* § 51 (May 2022).

[20] *Michaelson v. New England Tel. & Tel. Co.*, 404 A.2d 799, 809-10 (1979) (Citing *Narragansett Electric Co. v. Harsch*, 117 R.I. 395, 418, 368 A.2d 1194, 1208 (1977), Citing *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602, 64 S.Ct. 281, 287-88, 88 L.Ed. 333, 344-45 (1944).)

[21] "Used and Useful" rule, 73B C.J.S. Public Utilities § 51 (August 2022 Update).

[22] Record Request 23, at 3.

approving the rates. The application of the "used and useful" standard which I am suggesting is equally consistent with FERC accounting rules in that context.[23]

The Division appeared to have missed this point as well. The Division did not adequately address the relevancy of reducing greenhouse gas emissions in applying the ratemaking standards given the Act on Climate. Instead, the Division made only two passing references to the Act and expressed a concern that the proposal would be "tantamount to a denial of cost recovery" for the utility – concluding that the delays that occurred during the pandemic were now being adequately addressed.

The Division may have conflated the proposal to apply the "used and useful" standard as of the abandonment date with the straw proposal to halt AFUDC accumulation after the first service connection. However, there is no denial of cost recovery when the project is not treated as "useful" when the abandonment has not yet occurred. The change I am suggesting in how the Commission determines when the new main is used and useful simply provides a more relevant application of the ratemaking standard, given the Act on Climate. The utility would not be deprived of putting the capital cost in rate base. Rather, the change merely shifts the timing of recovery to the point when ratepayers are actually experiencing the benefits which the project is set out to achieve. The Commission would simply be making a finding, ***based on the evidence***, that the main replacement project has not been sufficiently completed to conclude that it is useful to the wide body of ratepayers. It is not a denial of cost recovery.[24]

Further, during the hearing on June 1, the Commission indicated that it would be important to address the question of who should be bearing the financial risk of delay in the abandonment. Specifically, I stated: "And I think if your conclusion is the ratepayer should bear the risk, then we need to understand there must be some offsetting reason why it's good for the ratepayers to bear that risk. . . . So, in your response it would be important to say we're okay with the ratepayers bearing that risk because it provides this other benefit . . . ."[25] The Commission, however, was not provided with any answer to this inquiry from either the Company or the Division.

Given these considerations, I intend to make a motion to change the timing of inclusion of new main in the ISR rate base. I would find that the leak-prone main replacement projects should no longer be treated as having been completed and "useful" for ratemaking purposes at the time of the first customer service connection. Instead, I would find, based on the evidence, that while the new main is being used, it is not yet "useful" enough for ratemaking purposes until the associated leak-prone pipe is abandoned. It may have limited usefulness during the transition toward abandonment, but it is not "very useful" to the wide body of ratepayers until the abandonment has occurred. As a consequence, it is not ripe for full rate base treatment to

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[23] *New England Tel. & Tel. Co. v. Public Utilities Commission*, 446 A.2d 1376, 1388 (R.I. 1982) ("the commission is not bound by the company's account books for rate-setting purposes.")

[24] The Company would not be deprived of recovering depreciation expense, because under the Commission's ruling depreciation expenses would not begin to accrue for ratemaking purposes until the project is placed into rate base after the abandonment occurs.

[25] Tr. June 1, 2022, at 156.

commence the cost recovery through rates.[26] Accordingly, subject to the conditions in our Order, the new main would be includable in ISR rate base only when the old main associated with the specific project has been taken out of service.

However, I recognize that there may be circumstances where it might be beneficial to ratepayers to install the new main even though it is clear at the time of planning that abandonment is not likely to take place within a reasonable period of time. Thus, I would allow the Company to seek an exception to the rule for individual projects at the time it is seeking approval of its ISR plan. However, the Company carries a high burden of proof to show the benefits to ratepayers of going forward with the particular replacement project are valuable to obtain even though the Company knows that abandonment of the leak-prone main is likely to be materially delayed.[27]

This change in the application of the used and useful standard which I am proposing would be prospective only. Because the Company has already undertaken projects during fiscal year 2023, I would propose that we do not apply this rate accounting rule for projects that were approved for the ISR 2023 fiscal year, or projects still pending from prior years. Rather, the new rule would take effect for all projects approved in the Company's next ISR filing.

Using a Portion of the AFDUC Allowance as a Service Quality Tool

While changing the ratemaking treatment for when the new main is considered to be used and useful is needed, I believe that the passage of the Act on Climate and the environmental policy that prioritizes reducing greenhouse gas emissions highlights the need for an additional economic signal. In that regard, I am concerned that while the Company might have the incentive to move projects into rate base, the financial consequence to the utility for delays is nevertheless substantially mitigated for shareholders when the Company can accumulate AFUDC over the delay period. As stated above, the Commission can always investigate the prudency of any delays, but it is inefficient and impractical for the Commission or the Division to conduct a prudency review on every leak-prone pipe main replacement project when projects are experiencing what appears to be an unacceptable delay in abandoning the leak prone pipe. Alternatively, the Commission has the authority to impose reasonable service quality penalties.[28] Given the authority of the Commission to implement service quality metrics, penalties, and/or financial incentives, I believe it is in the interest of ratepayers and in the interest of furthering the goals of the Act on Climate, to implement a service quality mechanism which provides financial consequences for unreasonable delays in shutting down the leak-prone pipe after the new main is gassed in.

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[26] Even when the Supreme Court defined the standard and used the horse and buggy example as an illustration, the Court stated: "A horse and buggy might conceivably be used in a modern facility, but it may not be ***very useful*** because of other modern-day modes of transportation." *Newport Electric, v. Public Utilities Commission*, 624 A.2d 1098, 1101 (R.I. 1993)(emphasis added).

[27] One hypothetical example might be a bridge project when the opportunities for doing a crossing will be limited, even though it means that a portion of the old main will have to remain in service for a longer period of time.

[28] *See In Re. New England Gas Company's Service Quality Plan*, Docket No. 3476 (2003).

In that regard, the Company has provided information which shows that the average number of days between the date when the first service is transferred to the new main and the date that the old main is abandoned from fiscal year 2016 through fiscal year 2022.[29] Excluding the two years that were affected by COVID (FY 2020 and FY 2021), the remaining 5-year average number of days is 55.[30] Using this historical information, I believe it would be reasonable to consider a service quality mechanism to incentivize the Company to complete abandonments within a reasonable period of time once the new main is gassed in and the first service connection is made. Rounding up the 5-year average to 60, it would be reasonable to require the Company to halt accumulation of AFUDC beginning with the first month after 60 days have passed from the date the new gas main has its first service connection.[31] The count of days, however, could be tolled for the months of December, January, and February to take into account the winter period during when service replacements might be affected by winter conditions.

A rule such as this would not be designed to deny cost recovery. It would provide an economic signal for the utility to plan its project execution such that projects are abandoned within a reasonable time after the new main is gassed in. This would appropriately place the risk of lengthy delays on the utility, rather than ratepayers.

The Company, however, indicated in response to a record request that it would be administratively burdensome to stop accumulating AFUDC for a project in the plant accounting system prior to the project being put into rate base, because it would require a manual intervention. Given this concern, I would be willing to consider other options which provide for an after-the-fact proxy adjustment which reasonably mirrors the effect of turning off AFUDC, or such other alternative which may be proposed which sends an appropriate financial signal. However, any alternative proposal should reflect the intention to provide a financial consequence for not completing the abandonment within a reasonable time after the first service connection is made to the new main. As such, I would offer the Company and the Division an opportunity to propose an alternative service quality penalty mechanism in the Company's next ISR filing. Accordingly, I would not order this AFUDC-related adjustment mechanism at this time. I would leave the decision regarding service quality penalties for consideration in the next ISR proceeding.

Regardless of the final decision regarding any service quality mechanism, I believe it would be important for the Company to include in its future annual Gas ISR reconciliations and its annual Gas ISR filings a report which identifies the status of each main replacement project, including (i) the date the project was gassed in, (ii) the date that the project received its first service connection to the new main, (iii) the actual or forecasted date of abandonment of the

[29] Attachment PUC 7-1.
[30] The average over seven years, including FY 2020 and FY 2021 is 71 days.
[31] In cases where there are no service connections, the time-period would commence when the new main is gassed in.

associated old main, (iv) the total capital cost of the project, (v) the number miles to be abandoned, (vi) the number of service transfers/replacements to be completed, and (vii) a brief description of the reasons for any delays.