NEW ENGLAND GAS COMPANY

DISTRIBUTION ADJUSTMENT CLAUSE FILING

RIPUC DOCKET NO. 3459

BEFORE THE
RHODE ISLAND PUBLIC UTILITIES COMMISSION

SUPPLEMENTAL TESTIMONY AND EXHIBITS
OF DAVID J. EFFRON

ON BEHALF OF THE

DIVISION OF
PUBLIC UTILITIES AND CARRIERS

OCTOBER 21, 2002

Q. Please state your name.

A. My name is David J. Effron.

Q. Have you previously submitted testimony in this docket?

A. Yes. I submitted direct testimony on September 30, 2002. My qualifications, background, and experience are included with my direct testimony.

Q. What is the purpose of this supplemental testimony?

A. First, the Company submitted "final ERI-2 earnings reports" on September 27, 2002, one business day before the due date for the Division's direct testimony in this docket. I am updating the calculation of over-earnings to incorporate the final earnings reports. Second, I am responding to the "Surrebuttal Testimony" of Sharon Partridge dated October 11, 2002. Third, the Division has not had all its requests for information satisfactorily resolved at the time of the preparation of this supplemental testimony. I am proposing a mechanism to allow the Division to continue investigating the results of operations for the period that ERI-2 was in effect, while recognizing the over-earnings determined to date.

1. Update to Over-earnings

Q. Have you revised your calculation of the earned returns on common equity for the twelve months ended September 30, 2001 and the twelve months ended June 30 2002?

A. Yes. As stated above, the Company submitted "final ERI-2 earnings reports" on September 27, 2002. Using these final earnings reports as a starting point, I have calculated a return on common equity of 14.41% for the twelve months ended September 30, 2001 and 8.73% for the twelve months ended June 30 2002. The weighted average annual return on common equity for this 21-month period was 11.58%. This exceeded the ceiling of 10.70% specified in ERI-2 by 0.88%, resulting in excess income of $893,000 per year. As the term of ERI-2 was 1.75 years, the excess income over this term was $1,562,000. This translates into excess revenue of $2,455,000 over the term of ERI-2 (Schedule DJE-3S).

Q. Does your calculation of the earned return include the same adjustments to the Company's position that were addressed in your direct testimony?

A. My calculations of the earned return on equity include all the adjustments to the Company's position that I made in my direct testimony with one exception, which I explain below. In addition, I am proposing an adjustment to revenue in this supplemental testimony.

Q. What is the adjustment to revenue that you are proposing?

A. The ERI-2 Agreement at Section II-F provides for funding of the following programs:

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.

3. The Low Income Weatherization Program will be funded at an annual level of $0.3 million for the first year $0.2 million for the second year.

Thus, the average annual level of funding for these programs is $1,850,000[1]. Providence Gas accounted for the funding of these programs as charges against revenue.

The earnings reports prepared by the Company show charges against revenue of $2,212,000 for funding the IRP programs in each of the reporting periods. Based on the ERI-2 Agreement, the charges against revenue to fund these programs should be no more than $1,850,000 per year. Therefore, I have increased the revenue for each of the reporting periods by $362,000 to reflect the funding of IRP programs authorized in the ERI-2 Agreement (Schedule DJE-1S, Page 2 and Schedule DJE-2S, Page 2).

Q. Why do the Company's charges against revenue for the IRP programs differ from the $1,850,000 per year specified in the ERI-2 Agreement?

A. There are two reasons. First, the Company included the incremental commitment of $250,000 from the Gas Purchasing Plan Settlement in the charges against revenue. This increased commitment was intended to be a contribution from shareholders, as noted by the Commission in its order accepting the Gas Purchasing Plan Settlement. Therefore, this incremental $250,000 should be eliminated from the cost of the IRP programs charged against revenues. Second, the Company double counted the Low Income Assistance Program costs for the three months of the two ERI-2 twelve-

[1] This reflects an average level of funding of $250,000 for the Low Income Weatherization Program, comprised of $300,000 in Year 1 and $200,000 in Year 2.

month periods that overlap. Correcting these two elements of the IRP costs charged against revenues by the Company results in an accrual of $1,850,000 per year.

2. Response to Surrebuttal

a. Federal Income Tax Rate

Q. Ms. Partridge claims that your use of a 35% federal income tax rate to calculate the income taxes included in operating expenses is erroneous. Do her criticisms of the 35% federal income tax rate have any merit?

A. None whatsoever. At the outset I should note that Ms. Partridge repeatedly refers to 35% as the ProvGas federal tax rate. This is not a proper description of the 35% income tax rate. The 35% that I use is the statutory federal income tax rate applicable to all corporate taxpayers with taxable income in excess of $10 million, not just Providence Gas Company.

Ms. Partridge states that my reliance on the income tax rate used in the earnings report that was filed with the testimony that became the basis for ERI-2 is improper. The use of the 35% rate to calculate income tax expense appeared on Schedule 3, Page 4 of the exhibit accompanying the testimony of James DeMetro dated August 1, 2000 in Docket No. 2581. In addition, New England Gas Company itself used the statutory tax rate[2], not an "effective tax rate" for the purpose of calculating the federal income tax expense to include in the cost of service in Docket No. 3401. Clearly, the statutory federal income tax rate was intended to be the

[2] New England Gas Company actually used a rate of 34% because the calculated taxable income was under $10 million in Docket 3401.

appropriate federal income tax rate for ratemaking purposes subsequent to the acquisition of Providence Gas Company by Southern Union.

Q. Is the 38% "effective tax rate" presented by the Company in any way relevant to the determination of the federal income tax expense for Providence Gas Company?

A. No. Based on Attachment SP-1, the so-called effective tax rate is higher than the statutory tax rate of 35% because of "Amortization/write-downs" apparently included in Southern Union's financial statements[3] that are not deductible for income taxes. There is absolutely no reason to believe that the non-deductibility of the "Amortization/write-downs" on the books of Southern Union affect the proper federal income tax rate applicable to Providence Gas for ratemaking purposes in any way.

The term "effective tax rate", as used by Ms. Partridge, is itself a misnomer. The amount of the "Amortization/write-downs" is not affected by income earned by Providence Gas. If income earned by Providence Gas increases by $1 million, the income tax expense increases by $350,000. Similarly, if income earned by Providence Gas decreases by $1 million, the income tax expense decreases by $350,000. Thus, the true effective income tax rate on income earned by Providence Gas is 35%. It is not 38%, which takes into account the effect of non-deductible expenses that have nothing to do with Providence Gas operations.

Q. Based on your experience, has the Rhode Island Public Utilities Commission used the statutory federal income tax rate to determine the income tax expense to include in the cost of service for ratemaking purposes?

A. Yes. To my knowledge, the Commission has always used the statutory federal income tax rate for ratemaking purposes. Therefore, use of the statutory rate to calculate the income taxes to include in operating expenses is consistent with established Commission ratemaking principles.

Q. Based on your experience, has the Commission ever used an "effective income tax rate" similar to the 38% used by Ms. Partridge to determine the income tax expense to include in the cost of service for ratemaking purposes?

A. No. To my knowledge, the Commission has never used a so-called effective income tax rate for ratemaking purposes. Therefore, use of the "effective income tax rate" described by Ms. Partridge to calculate the income taxes to include in operating expenses would not be consistent with established Commission ratemaking principles and would violate the ERI-2 Settlement Agreement.

b. Interest Rate

Q. In her surrebuttal testimony, Ms. Partridge claims that you are "proposing to rely on the weighted cost of debt (7.38%) suggested by the Division's witness (Mr. Kahal) in Docket 3401." Is there any basis for such a claim?

A. No. I have no idea what Ms Partridge's testimony is referring to. I did not modify the cost of long-term debt used by the Company in its earnings reports. My only proposal in this area was to include short-term debt in the capital structure. The only thing for which I relied on Mr. Kahal's testimony in Docket 3401 was the cost rate of

[3] Which do not reflect established Commission ratemaking principles

short-term debt, not long-term debt[4], that he recommended. As far as I can tell, Ms. Partridge has not disputed my inclusion of short-term debt in the capital structure or the cost rate that I assigned to that short-term debt[5].

c. Prepayments

Q. Would the inclusion of prepayments in rate base be consistent with established Commission ratemaking principles for Providence Gas?

A. No. As I stated in my direct testimony, neither the rate base calculations accompanying the quarterly reports filed pursuant to ERI-1 nor the rate base determination in Docket No. 2286 included prepaid expenses in rate base. The ERI-1 reports are relevant because they are documents submitted to the Commission and presumably reflect the relevant Commission principles. To speculate that the exclusion of prepayments from rate base in those reports was somehow inadvertent is without any foundation in fact. The last rate case for Providence Gas, Docket No. 2286, did not include prepayments in rate base, and the ERI-1 reports were consistent with the Commission findings in that case. Ms. Partridge has not cited any Commission precedent that would allow Providence Gas to include prepayments in rate base in its ERI-2 reports. Therefore, prepayments should not be included in rate base.

d. Adjustment to Operations Expense

[4] Mr. Kahal actually proposed a cost rate of 7.81%, not 7.38%, for long-term debt.
[5] The rate for short-term debt proposed by Mr. Kahal in Docket 3401 was the average actual rate for 2001.

Q. Ms. Partridge challenges your adjustment to eliminate $72,000 from operation expenses for the twelve months ended June 30, 2002. Is her point valid?

A. Yes. The $72,000 should be removed from actually incurred operation and maintenance expense. However, since the actual operation and maintenance expense for the twelve months ended June 30, 2002 was higher than the capped expense included in the earnings report, the removal of the $72,000 does not affect that calculation of the earned return on equity. I have modified my calculation of the earned return accordingly.

e. Administrative and General Expenses

Q. Ms. Partridge states that an investigation of the administrative and general expense will not have any impact on the earned return calculation because the ERI-2 Settlement Agreement states "there will be no adjustments to actual results to recognize or annualize known and measurable changes." Is her interpretation of the ERI-2 Agreement correct?

A. No. The cited language in the ERI-2 Agreement excludes any pro forma adjustments, such as those for wage rate changes. However, if the administrative and general expenses included costs that were not recoverable from ratepayers pursuant to established Commission ratemaking principles or included accruals or charges properly attributable to a different period[6], then elimination of such costs would be permitted, in fact required, by the ERI-2 Agreement. The investigation of

[6] These are examples, not an exhaustive list, of possible adjustments that would be appropriate based on the ERI-2 agreement.

administrative and general expenses for the twelve months ended June 30, 2002 could well have an effect on the earned return calculation.

f. Period for Excess Income

Q. Ms. Partridge objects to your multiplying the annual rate of excess earnings by 1.75 to calculate the excess earnings for the ERI-2 term. Can you explain why it is appropriate to multiply the annual rate of excess earnings by 1.75?

A. Yes. The return on equity calculation reflects the income for a one-year period divided by the average balance of common equity for that same period. The only reason that the ERI-2 Agreement did not explicitly state that the annual rate of excess earnings (if any) would be multiplied by 1.75 is that it is self evident that such a step is necessary to calculate the amount of excess revenue applicable to the ERI-2 term of 1.75 years. That is, if rates for Providence Gas produced excess income of $893,000 <u>per year</u>, on average, over the term of ERI-2, then it should be obvious, as a matter of simple arithmetic, that total excess income for a 1.75 year period is 1.75*$893,000, or $1,562,000.

If ERI-2 were in effect for only one year and the earned return on equity for that one year was 11.58%, then it would not be necessary to multiply the excess earnings by the term of the plan[7] to determine the excess earnings for the period. It then follows that if ERI-2 was actually in effect for 1.75 years and the average earned return on equity for that 1.75 year period was 11.58%, then the average <u>annual</u> excess

[7] Or to multiply the excess by one, which is the mathematical equivalent of not multiplying the annual excess earnings by any factor in this hypothetical example.

earnings during that period must be multiplied by 1.75 to calculate the excess earnings over the entire 1.75 year term.

When the ERI-2 Agreement states that any earnings in excess of 10.70% shall be credited to the DRA, it clearly means any excess earnings over the 1.75 year term of ERI-2. The only way to achieve that result is to multiply the excess earnings per year by 1.75. Failure to multiply the average annual excess earnings by 1.75 would be improper. The absence of an explicit statement in a settlement agreement that proper mathematical procedures will be applied should not be interpreted to mean that it was the intent of the parties to permit the application of improper procedures.

3. Continuing Investigation

Q. Does the $2,455,000 represent the Division's final determination of excess revenue for the term of ERI-2?

A. No. As stated above, the Company submitted its "final ERI-2 earnings reports" on September 27, 2002. Those final earnings reports generated additional potential issues, which the Division is still in the process of analyzing. Further, the Division is still investigating the administrative and general expenses for the twelve months ended June 30, 2002 to determine whether there should be any adjustments for the purposes of the earnings reports.

Q. Do you have a proposal as to how the Commission should accommodate the continuing investigation?

A. Yes. The DAC applicable to customers of the former Providence Gas Company effective November 1, 2002 should reflect a credit of $2,455,000 for excess revenue earned by Providence Gas over the term of ERI-2, based on the results of the investigation to date. 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, along with appropriate interest from November 1, 2002, should be credited to the DAC effective November 1, 2003.

Q. Does this conclude your supplemental testimony?

A. Yes.