THE STATE OF NEW HAMPSHIRE

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Thomas B. Getz

COMMISSIONERS
Graham J. Morrison
Clifton C. Below

EXECUTIVE DIRECTOR
AND SECRETARY
Debra A. Howland

PUBLIC UTILITIES COMMISSION
21 S. Fruit Street, Suite 10
Concord, N.H. 03301-2429

Tel. (603) 271-2431

FAX (603) 271-3878

TDD Access: Relay NH
1-800-735-2964

Website:
www.puc.nh.gov

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N.H. PUBLIC UTILITIES COMMISSION

Debra Howland
Executive Secretary and Director
New Hampshire Public Utilities Commission
21 South Fruit Street, Suite 10
Concord, New Hampshire 03301

Re: DG 07-033 Northern Utilities, Inc.
2007 Summer Cost of Gas

Dear Ms. Howland:

Enclosed for filing with the Commission on behalf of Commission Staff and the Office of Consumer Advocate is a Joint Brief in the above captioned docket.

Thank you for your attention to this matter.

Sincerely yours,

F. Anne Ross
Staff Attorney

Cc: Service List

BEFORE THE NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION

DOCKET NO. DG 07-033

PETITION FOR APPROVAL OF 2007 SUMMER SEASON COST OF GAS
NORTHERN UTILITIES, INC.

BRIEF OF STAFF AND OFFICE CONSUMER ADVOCATE REGARDING
NORTHERN'S RECONCILATION CALCULATION AND
DOUBLE RECOVERY OF CARRYING COSTS

I. INTRODUCTION

Following a hearing on the merits on April 23, 2007the Commission, by Order No. 24,743, allowed the parties to this docket an opportunity to submit briefs on two issues: (1) the over-collection of the cost of timing differences between the payment of gas supply costs and the receipt of gas revenues; and (2) the appropriate carrying charge rate to calculate the cost of supply-related cash working capital.

By Secretarial letter issued May 23, 2007, the Commission notified the parties to this docket that the issue of the carrying charge rate on cash working capital would be considered in a separate docket. Staff and the Office of Consumer Advocate (OCA) submit this Brief to further develop their position with regard to the over-collection of the cost of timing differences between the payment of gas supply costs and the receipt of gas revenues.

II. BACKGROUND

In this docket, Northern Utilities ("Northern") requests authorization from the Commission to continue to use the existing mechanism for calculating and reconciling gas cost under/over collections. Every six months, Northern files with the Commission a proposed Cost of Gas ("COG") rate for the upcoming six months. In addition to the direct gas costs, the COG rate covers several other costs that relate to gas supply service.

For example, in its COG filing for the 2006-07 winter period[1](2006-2007 winter COG), Northern sought to recover: (i) direct gas costs of $40,052,618; (ii) under-collected costs of $2,122,758 for the prior winter period that included $264,222 in carrying charges; and (iii) carrying charges of $76,065 on cash working capital. At the October 18, 2006 hearing on Northern's 2006-2007 winter COG, Staff and OCA expressed concerns that the collection of carrying charges on both monthly under/over collection balances and monthly cash working capital requirements may result in the over-collection of timing difference costs.

In Order No. 24,684, Docket DG 06-129, *Northern Utilities 2006-2007 Winter Cost of Gas*, the Commission directed the parties and Staff to meet to discuss their differences and to file a report on the results of their discussions. Staff and the OCA filed a joint report with the Commission on March 15, 2007 that presented their views on the cost over-collection issue.

In the March 15, 2007[2] report, Staff and the OCA argued that authorizing Northern to continue to use the existing mechanism for calculating and reconciling gas cost under/over collections would continue the practice of over-collecting gas costs. Specifically, Staff and OCA argued that the combination of the existing reconciliation mechanism and the allowance for supply-related cash working capital over-collects timing difference costs. In order to rectify this problem, Staff and OCA recommended

[1] Docket 06-129
[2] This report was filed in Northern's prior winter period cost of gas docket, DG 06-129, and subsequently filed in this docket as well.

that Northern's reconciliation mechanism be modified by replacing billed revenues with accrued revenues. This change would eliminate the mismatch between accrued costs and billed revenues in the reconciliation mechanism and would reduce the amount of the over-collection.

Staff filed direct testimony in the current proceeding on April 16, 2007, that summarized the report's findings and explained how the report's recommendations resolve the over-collection problem. *See,* Docket DG 07-033 *Northern Utilities 2007 Summer Cost of Gas,* Exhibit 5. Testimony rebutting Staff's testimony was filed by Northern on April 20, 2007. *See, Id*. Exhibit 4.

III. ARGUMENT

A. NORTHERN'S COST OF GAS RECONCILATION MECHANISM BUILDS IN TIMING DIFFERENCES ALREADY CAPTURED IN THE LEAD/LAG STUDY

Northern is authorized to collect through the COG rate the cost to finance its supply-related cash working capital. Supply-related cash working capital is the investor-supplied cash needed to finance the net lag[3] between the payment of gas supply costs and the receipt of the gas supply revenues. The amount to be collected is a function of the net lag length expressed in days, which is generally determined with the aid of a lead/lag study.[4]

Northern's most recent lead/lag study was submitted in DG 01-182 and recommended an average net lag of 6.33 days per month. That study took into account several factors that determine when customer payments are received and supplier costs are paid

[3] A net lag or lead is commonly referred to as a timing difference.
[4] A lead/lag study is a systematic procedure for determining the average number of days investors supply working capital to operate the utility. When conducting such studies, it is appropriate to consider both the working capital requirements associated with revenue lags as well as the offsetting working capital requirements associated with expense leads.

including the fact that customer meters are read on average 15.2 days after consumption. Exhibit 4, page 9. The Commission approved the recommended net lag in Order No. 24,075 (October 28, 2002). Assuming the DG 01-182 study was conducted properly, which is Northern's position and is supported by Staff and OCA, then the cash working capital component of the COG rate should fully compensate Northern for the cost of timing differences. Exhibit 5, page 7. Stated differently, a second adjustment to the COG rate to recover the cost of timing differences is unnecessary.

The March 15 report, however, shows that timing differences do contribute to the monthly over/under collection balances in Northern's COG reconciliation calculation and, hence, to an over-collection of carrying costs. Specifically, using Northern's reconciliation calculation for the 2005-2006 winter period, the March 15 report shows that billed revenues lag accrued costs by on average 15 days each month, the same time interval already reflected in Northern's lead/lag study for the average lag between gas consumption and meter reading.

B. THE SOURCE OF THE TIMING DIFFERENCES IN THE RECONCILIATION CALCULATION IS NORTHERN'S FAILURE TO PROPERLY MATCH REVENUES WITH COSTS.

Attachment 1 of Exhibit GRM-2 to Exhibit 5 is a copy of Northern's reconciliation calculation for the 2005-06 winter period, which extends from November 2005 through April 2006.[5] Each monthly gas cost shown in the attachment represents the cost of the gas consumed in that month. The same accrual accounting concept was not used, however, to develop the monthly revenues shown in the attachment. Instead, the

[5] The schedule actually spans 13 months because: (i) certain summer costs are deferred for recovery during the winter period; and (ii) an extra month is added to reflect the fact that some of the revenue associated April gas consumption is not billed until May.

monthly revenues shown in the attachment are based on billed revenues. Generally, under a billed revenue accounting approach, revenue associated with gas consumed in one month (e.g., December) but not billed until the next month (i.e., January) is assigned to the next month. Northern employs this convention in all months except October. Revenue associated with gas consumed in October but billed in November is not assigned to November because Northern regards October as a summer month and, therefore, any consumption in that month is considered outside of the winter period. However, because this results in the assignment of only 15 days of consumption to November, Northern includes in its reconciliation calculation an additional 15 days of revenue in May in order to ensure a six month matching of costs and revenues. The May revenue is associated with gas consumed in April but billed in May.

The important point to draw from this analysis is that the stream of billed revenue in the attachment effectively begins on the 16th day of November and ends on the 15th day of May. Stated differently, the billed revenue stream lags accrued gas costs by on average 15 days.

Mr. Ferro claims there are no net lag days reflected in the calculation of carrying costs on under/over collections. Transcript, page 89. For the reasons provided above, Mr. Ferro is clearly mistaken. The net lag reflected in the calculation of monthly under/over collection balances is on average 15 days per month. Furthermore, Mr. Ferro’s assertion is not supported by any analysis.

C. NORTHERN'S ASSERTION THAT MONTHLY OVER/UNDER COLLECTION BALANCES ARE BASED ON THE MATCHING OF 30 DAYS OF COSTS AND 30 DAYS OF REVENUES IS CONTRADICTED BY THE COMPANY'S OWN RECONCILATION SCHEDULE.

In an attempt to support the contention that the reconciliation calculation does not reflect timing differences, Mr. Ferro testified that monthly under/over collection balances are based on 30 days of revenues and 30 days of costs. Transcript page 93. A review of Attachment 1 of Exhibit GRM-2 to Exhibit 5 reveals, however, that the revenue entry for November 2005 does not reflect a full month, or 30 days of consumption. As explained in Argument B above, the reason is that the revenue associated with November consumption billed in December is assigned to December, which is approximately 15 days. In contrast, the revenue associated with October consumption billed in November, or again approximately 15 days, is not assigned to November.

Furthermore, the Commission should note that Mr. Ferro contradicted his own testimony on this point. Referring to Attachment 1 to Exhibit 5, Mr. Ferro states that "in November '05, they show -- [Northern] show[s] billed revenues that's a half month of prorated revenues for the winter period." Transcript page 92. The fact that Mr. Ferro goes on to argue that the other half of the November billed revenue is tacked onto the end of the summer period reconciliation is of no consequence because that accounting fails to eliminate the carrying costs that result from matching in November a full month of gas costs with half a month of revenue. The Commission should also note that the under-collection resulting from this November mismatch impacts the monthly balances during the rest of the winter period and in the process burdens customers with additional carrying costs.

D. NORTHERN INCORRECTLY TESTIFIED THAT THE COSTS REFLECTED IN THE CALCULATION OF MONTHLY OVER/UNDER COLLECTION BALANCES ARE BASED ON BILLINGS IN THE MONTH RATHER THAN ACCRUAL ACCOUNTING.

Mr. Ferro declared during the hearing that the costs reflected in the reconciliation calculation are not accrued costs as claimed by Staff but “actual” costs. Transcript, pages 91-92. He defined actual costs to be the costs recorded at the end of each month for gas either “billed out” or “charged”. Mr. Ferro’s testimony is contrary to Northern’s response to Staff 2-3 in DG 06-129, which states in relevant part that the “costs of firm gas allowable through the Cost of Gas Clause are incurred in the month [gas is] utilized, and recorded as an expense at the end of that month.” As is clear from the response, the costs reflected in the reconciliation calculation have nothing to do with customer billings or supplier charges. In fact, the statement that the costs are incurred in the month gas is utilized is proof that the Company employs accrual accounting for gas costs.

When pressed on this point during cross-examination, Mr. Ferro conceded as much in the following exchanges (Transcript pages 105-106):

Q. …My understanding is that your gas supply costs that you incur in November are, actually, there’s about a lag of 40 days till payment.”

A. Yes….

Q. ….My point is, you are calling these costs “actual costs”, but those costs actually aren’t paid until late December, correct?

A. Just as our revenues aren’t paid until sometime well in the future.

Q. The revenues are not received until later?

A. Well in the future.

While in reality Northern does bill and collect a full month of revenue every month, the monthly over/under reconciliation calculation that determines the amount of carrying costs to be collected from customers each month does *not* include a full month of revenues in the first month of each season, although it does include a full month of costs. Support for this view is provided in Attachment 1 of Exhibit GRM-2 to Exhibit 5, which shows how carrying costs are currently calculated. In contrast, Schedule JAF-1 in Exhibit 4, which includes out-of-season revenues in the first month's average balance, is not consistent with the current method of calculating carrying costs on monthly over/under collections.

E. NORTHERN HAS FAILED TO SUPPORT ITS ASSERTION THAT THE LEAD/LAG STUDY AND, HENCE, THE CASH WORKING CAPITAL ALLOWANCE DOES NOT PROVIDE COMPENSATION FOR DIFFERENCES IN MONTHLY COSTS AND REVENUES ATTRIBUTABLE TO: (i) BROAD VOLUMETRIC CHANGES THAT OCCUR WHEN MOVING FROM THE SUMMER TO WINTER GAS SEASON; AND (ii) CYCLE BILLING.

1. Volumetric Changes

Exhibit 6 shows that the average revenue lag from billing to collection is calculated in Northern's lead/lag study using monthly accounts receivable balances. As is evident from the exhibit, the winter month balances are considerably higher than the summer month balances, reflecting the change in volumes that occur when moving from the summer to the winter gas season, thereby increasing the annual average balance. Thus, Exhibit 6 flatly contradicts Mr. Ferro's assertion that the lead/lag study does not compensate Northern for the impact of volumetric changes on cash working capital. Transcript, page 109.

The above notwithstanding, Northern has failed to explain how the volumetric changes that accompany the change from summer to winter create greater differences between monthly costs and revenues.

Accepting for the sake of argument that broad volumetric changes do create greater differences between monthly costs and revenues and that these differences are attributable to longer revenue lags, Northern has not explained why these longer revenue lags would not be offset by shorter revenue lags when moving from the winter to the summer gas season. In addition, assuming the greater differences between monthly costs and revenues are not attributable to variations in revenue lag, Northern has not explained why a reconciliation calculation based on accrued costs and revenues would not provide sufficient compensation for these larger imbalances.

2. Cycle Billing

Assuming an equal number of customers in each billing cycle and that billing cycles are spread uniformly throughout each month, it can be shown that meter reading lags consumption on average by 15.2 days. The fact that this service lag is reflected in Northern's lead/lag study contradicts Mr. Ferro's assertion that the allowance for cash working capital does not compensate the Company for differences in monthly costs and revenues attributable to the billing cycle. Exhibit 4, page 9.

F. NORTHERN'S ASSERTION THAT THE CASH WORKING CAPITAL ALLOWANCE DOES NOT FULLY COMPENSATE THE COMPANY FOR THE COST OF FINANCING THE REVENUE LAG IS UNPROVEN.

In testimony presented to the Commission, Mr. Ferro stated that the cash working capital component of the COG rate recovers only the <u>average annual</u> cost of financing the lag between the receipt of gas supply revenues and the payment of gas supply costs. According to Mr. Ferro, the cash working capital allowance does not fully collect the costs associated with financing the monthly differences between the costs the Company incurs versus the revenues the Company bills out (i.e. timing difference costs). He attributed this under-collection to the temperature-sensitive nature of Northern's customer load. Transcript, page 87-88 and Exhibit 4, page 10. Mr. Ferro went on to say that because the cash working capital allowance does not collect all timing difference costs, it is appropriate for the reconciliation mechanism to collect such costs.

The problem with this argument is threefold. First, Mr. Ferro has not demonstrated, either qualitatively or quantitatively, that the net lag resulting from the Company's lead/lag study actually under-collects timing difference costs. Stated differently, Mr. Ferro has yet to make the case, through sound argument or empirical analysis, that if revenue lags and/or expense leads were calculated on a monthly basis rather than annually the sum of the monthly timing differences would be different from the timing difference under the current approach. That said, the Commission should be aware that the current method of estimating the average number of days that revenue receipts lag gas consumption is based on monthly data, as is the current method of estimating the average number of days that gas supply payments lead gas consumption. These facts contradict Mr. Ferro's assertion that the methodology underlying the current lead/lag study does not incorporate monthly data.

Second, assuming the revenue lag does increase as the weather becomes increasingly colder, Northern conveniently omits to consider the effect on the revenue lag as the weather becomes increasingly warmer in the second half of the winter. Using the same logic, the revenue lag should decrease as the weather becomes warmer.

Third, even assuming the temperature-sensitive nature of gas demand distinguishes gas distribution companies from the electric distribution companies, Northern has not demonstrated that the additional compensation provided through the current reconciliation mechanism is limited to the costs not collected through the cash working capital allowance.

G. NORTHERN'S ARGUMENT THAT THE CURRENT MECHANISM FOR CALCULATING INTEREST ON MONTHLY UNDER/OVER COLLECTION BALANCES IS REASONABLE BECAUSE IT HAS BEEN IN PLACE FOR OVER 30 YEARS IS NOT CREDIBLE .

While it may not be unreasonable to argue that the longer a rate mechanism has been in place without change the less likely it is that regulators will find it to be defective, it would most certainly be unreasonable to conclude, as Northern apparently does, that a mechanism that has been in place for an extended period of time must be perfect. Northern would have the Commission believe, in effect, that a rate mechanism that was defective when it was implemented will miraculously repair itself with the passage of time. The evidence in this case suggests otherwise.

H. NOTHERN'S ARGUMENT THAT STAFF BEARS THE BURDEN OF PROOF REGARDING NORTHERN'S RECONCILIATION CALCULATION IGNORES THE COMMISSION'S PLENARY AUTHORITY OVER RATES

At hearing Northern argued that the Commission should deny Staff's recommendation to change its COG mechanism stating that Staff had not "met its burden of proving to the Commission by a preponderance of the evidence that this methodology should be changed or that it produces unjust or unreasonable rates." Transcript page 134. The Commission's rate setting authority is broad and well established. "Whenever the commission shall be of opinion, after a hearing had upon its own motion or upon complaint, that the rates, fares or charges …are unjust or unreasonable…the commission shall determine the just reasonable or lawful rates, fares and charges …" RSA 378:7 The rate setting statutes do not provide any burden of proof for non-utility parties. In this case, as well as the winter 2006-2007 case, Northern asked the Commission to approve COG rates. In both cases the Commission is entitled to base its rate determination upon a preponderance of the evidence regardless of which party produced that evidence. Merely placing a reconciliation mechanism in its COG rate filings does not mean that the Commission must accept that mechanism without further scrutiny.

CONCLUSION

Based upon the evidence developed at hearing and through discovery Staff and the OCA recommend that the Commission instruct Northern to replace billed revenues with accrued revenues in its COG mechanism and recalculate the 2005-2006 winter and 2006 summer reconciliations using accrued revenues, as the issue was first raised by Staff in the 2006-2007 Winter COG.

Respectfully submitted,

STAFF OF THE NEW HAMPSHIRE PUBLIC UTILITIES COMMISSION
By their attorney,

_______________________________ Date: _____________________
F. Anne Ross, Esq.

OFFICE OF CONSUMER ADVOCATE

_______________________________ Date: _____________________
Meredith A. Hatfield, Esq.