STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

DG 10-017

In the Matter of:
EnergyNorth Natural Gas, Inc d/b/a National Grid NH
Petition for Permanent Rate Increase

Direct Testimony

of

Stephen P. Frink
Assistant Director – Gas & Water Division

October 22, 2010

Table of Contents

New Hampshire Public Utilities Commission

EnergyNorth Natural Gas, Inc. d/b/a National Grid NH

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Testimony of
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Q. Please state your name, occupation and business address.

A. My name is Stephen P. Frink and I am employed by the New Hampshire Public Utilities Commission (Commission) as Assistant Director of the Gas & Water Division. My business address is 21 S. Fruit Street, Suite 10, Concord, New Hampshire 03301.

Q. Please summarize your educational and professional experience.

A. See ***Attachment SPF-8***.

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to provide Staff's recommendations for a revenue requirement for EnergyNorth Natural Gas, Inc. d/b/a National Grid NH (National Grid or the Company), recovery of bad debt write-off related to related gas costs, how to treat excess capacity identified by Mr. McCluskey in the Integrated Resource Plan (IRP) proceeding and how to treat an adverse finding by the Internal Revenue Service (IRS) related to a National Grid accounting change.

Q. Please summarize Staff's recommendations on these issues.

A. Staff recommends an increase in the revenue requirement of $3,007,361. That the actual gas cost-related bad debt less a percentage related to substandard collection practices be collected through the cost of gas (COG). That no adjustment to the revenue requirement be made at this time to eliminate excess supply capacity. That National Grid be allowed to recover taxes and interest resulting from an unfavorable ruling by the IRS related to National Grid's accounting change.

Q. Are temporary rates currently in effect in this docket?

A. Yes. On May 14, 2010 the Commission issued Order No. 25,104 authorizing a temporary revenue requirement increase of $5.0 million, resulting in an increase in customer bills of 2.8%, on average. Temporary rates went into effect June 1, 2010. The proposed permanent revenue requirements are unrelated to the temporary rate revenue requirement.

Q. What is the increase to the revenue requirement proposed by National Grid?

A. On February 26, 2010, National Grid filed testimony and schedules requesting an additional $11.4 million in annual revenues, representing a 6.5% increase. ***See Attachment SPF-1.***

Q. What is Staff's recommendation with respect to a revenue requirement?

A. Staff recommends that National Grid be granted a $3,007,361 increase in annual revenues, representing a 1.71% increase. ***See Attachment SPF-1.***

Q. Briefly describe National Grid's filing.

A. As noted above, National Grid is seeking an $11,422,717 increase in its annual revenue requirement. National Grid's revenue requirement is based on a test year ending June 30, 2009 and rate base as of September 30, 2010, with a return on equity of 11.5%.

In addition, the Company proposed to: modify its annual cast iron/bare steel rate adjustment mechanism to include public works projects and eliminate the current threshold of $500,000 in expenditures prior to obtaining cost recovery; an annual rate adjustment mechanism for pensions, OPEBs, and commodity related bad debt; an annual inflation adjustment net of an assumed productivity factor of certain operating expenses; full revenue decoupling to remove the link between revenues and the metered sales; and, increased customer charges designed to recover a greater percentage of fixed costs through fixed charges.

Q. Please describe Staff's review of the filing.

A. Staff issued three rounds of discovery, held three substantive technical sessions and performed a comprehensive audit. In performing its audit, the Commission Audit Staff issued numerous audit requests, issued a draft report, discussed the report and its finding with the Company and issued a final report on August 16, 2010. The Company agreed to make a number of changes based on the audit report and discovery and plans to file a revised rate schedules.

Revenue Requirement

Q. How was Staff's revenue requirement calculated?

A. As shown on Attachment SPF-1, Staff recommends an increase in the revenue requirement of $3,007,361 based on pro formed test year income of $10,930,981, as detailed on SPF-2. The increase is 1.71% over total test year revenue and 6.69% over test year delivery revenues. This revenue requirement is calculated on total rate base of $167,670,003, as detailed on SPF-3, and provides for an overall rate of return of 7.59%, shown on SPF-4, consistent with the testimony of Staff witness Dr. John Wilson.

Q. Please explain how Staff's schedules were developed.

A. Staff's schedules began with the National Grid schedules and made adjustments to the Company's pro-formed schedules. Company data responses referred to in my testimony and attachments are included in numerical order at the end of the attachments.

Q. Why did Staff begin with National Grid's pro-formed test year schedules?

A. For the most part, Staff agrees with the pro forma adjustments made by National Grid. National Grid has agreed to a number of changes as a result of the audit report and discovery process and has provided a list of the agreed upon changes. DR Staff Tech 3-43. The net impact of those changes is reflected in Staff's schedules and the data response that lists and describes each of the adjustments is attached. Staff's testimony and schedules only addresses adjustments beyond those the Company and Staff have already agreed on.

Q. What areas did Staff adjust and what is the basis for those adjustments?

A. Staff adjusted the return on equity as recommended and explained by Dr. Wilson. Rate base was adjusted to reflect rate base as of June 30, 2009 (plant balances at the end of the test year) and for an accounting change that occurred in December 2009 which restated the deferred tax balance. Revenues were adjusted to reflect the incremental increase resulting from a full year of revenue from main and service extensions related to revenue growth and residential non-heat customers converting to heating service. Expenses were adjusted to eliminate non-recurring items, eliminate test year expenses that should have been excluded per Commission rules, reflect known and measurable changes in the 12 months following the test year and to reduce the Company's bad debt expense that could have been avoided through better collection practices.

Rate Base Adjustments

Q. What are Staff's rate base adjustments?

A. Staff accepts the Company's pro forma adjustments related to year end rate base but has eliminated National Grid's post test year adjustments and questions the accumulated deferred income tax balance.

Q. What is Staff's rate base recommendation?

A. $167,670,003, derived from reversing the Company's adjustments related to post year plant additions as described below. ***See Attachment SPF-3***

Q. What adjustments did National Grid make for post test year plant additions?

A. National Grid increased rate base for actual and projected non-revenue producing capital investments through September 30, 2010. The Company also updated the depreciation reserve and deferred income tax for that period.

Q. What is the impact of adding post test year capital on net utility plant in service?

A. National Grid included forecasted non growth capital of $9,575,890 and increased the depreciation reserve by $6,466,136 resulting in a net increase of $3,109,754.

Q. What is the impact of updating the deferred income tax?

A. Updating the deferred income tax for post test year additions increased deferred income tax by $2,400,000. In its filing National Grid increased the deferred income tax by $3,000,000 related to plant additions in Fiscal Year 2010 and 2011; $2,000,000 for Fiscal Year 2010 (April 2009 through March 2010) and $1,000,000 for one half of Fiscal Year 2011 (April 2010 through September 2010). Since the test year includes one quarter of Fiscal Year 2010 and the Company has identified $600,000 of the $2,000,000 adjustment as being related to test year plant additions, the post test year additions would account for $1,400,000 of the Fiscal Year 2010 adjustment to deferred income tax. DR Staff Tech 3-22.

Q. What is the impact on rate base as a result of adding post test year plant?

A. Rate base is increased by $709,754 as the $3,109,754 increase in net plant in service is offset by a $2,400,000 increase in deferred income tax.

Q. Why did National Grid include post test year rate base?

A. The Company claims that it has made substantial non-revenue producing investments since the end of the test year and including those investments in rate base is more representative of the Company's current financial status and investment than using a traditional 13-month average rate base. And, given the flat or declining consumption the Company has been experiencing, the historical ratemaking process does not provide the Company with a meaningful opportunity to earn its allowed rate of return. *Lombardo/Adams testimony p. 42 of 51.*

Q. Does Staff agree that including post test year plant additions is more representative of current financial status and investment than a 13-month average?

A. No. Including post test year plant may be more representative of the Company's current plant investments but Staff can not confirm whether those investments are non-growth related, have been accurately reported, were prudently incurred and are used and useful. In addition, there is no way of knowing what impact those investments may have on the Company's earnings. For example, some investments may not be directly tied to growth, but if, upon replacement, the pipe size is increased, leak prone pipes are removed or the system reinforced, then the investments may still contribute to growth. In such a case the investments could generate additional revenues and/or lead to lower operation and maintenance costs.

In addition, while the procedural schedule does allow for a comprehensive examination of the initial filing, it does not provide for the filing and review of 18 months of plant investments since the end of the test year. The Commission Audit Staff filed its Final Audit Report, as scheduled, on August 16, 2010 and Staff and Intervenor testimony is due October 22, 2010. Even if the Company were able to file that information shortly after the close of its September books, time would not allow for a comprehensive review of the material prior to the submission of testimony.

Q. Does Staff accept the Company's argument that due to flat or declining consumption failing to include post test year investment in rate base will not provide the Company a meaningful opportunity to earn its allowed rate of return?

A. No, for several reasons.

First, consumption on the National Grid system is expected in increase. While sales have been relatively flat over the last few years, overall sales are increasing and are expected to continue increasing. From 2002 to 2009 normalized sales increase from 135 million therms to 145 million, with only two years reflecting a decline in sales, the sharpest being a 5,000,000 decline in 2009 which coincides with the severe recession. DR Staff 1-37. And if one looks at the at total gas sales from marketing reports, which are based on estimated usage of actual customers added to the system, there has been an increase in annual sales every year for the past five years, including 2009. DR Staff 1-53. National Grid's Integrated Resource Plan (IRP) filed on February 26, 2010 in Docket No. DG 10-041 projects average growth of 2.6 percent per year under normal weather conditions for the forecast period, November 1, 2010 through October 31, 2015. Furthermore, National Grid's corporate strategy may be inhibiting the rate of growth, as discussed in Mr. Knepper's testimony. If the Company were to pursue an aggressive growth strategy here in New Hampshire it may be able to accelerate the growth rate, particularly given the favorable cost of natural gas compared to oil and propane. It is noteworthy that in spite of a severe recession and stagnant economy National Grid has continued to experience growth on its system and is forecasting an increase in the sales growth rate.

Second, in recognition of the reduced sales growth and state of the economy, Staff has deviated from traditional rate making by using year-end rate base rather than a 13-month average. Test year revenues have been adjusted to account for an increase in earnings related to capital investment in mains and services related to growth. Staff does not adjust revenues for other test year growth related capital investments even though the revenue from those investments would not have been or is not fully realized in test year revenue and can be expected to boost future earnings in subsequent years. Furthermore, the use of year-end rate base allows for full recovery off all non-growth investments, and some growth related investments, made during the test year. Test year capital projects included in rate base total $18,325,709, of which $7,410,803 is expected to generate additional revenue. Of the $7.4 million of capital projects expected to be revenue producing, Staff only reflected the additional revenue expected on $4,624,185 of main and service capital additions. *Fleck testimony Attachment 1 p. 1 of 17.*

Third, the Company's plan to spend $63 million in non-growth related capital projects seems excessive and is not based on specific, required projects. The testimony of Company witness Tierney (p. 13 of 69) notes that the Company's capital expenditures rose dramatically over the past few years, more than twice as fast as non-commodity/non-production operations and expenses. On p. 23 of 69 of her testimony she states, "Use of a test-year average rate base in an environment where there is (1) little or no growth in customers, (2) flat natural gas usage per customer, and (3) a substantial ongoing need for non-growth-related capital investment makes it effectively impossible for the Company to earn the rate of return authorized by the Commission regardless of what that return is." The fact is, there has been growth and the Company is forecasting an increased growth rate over the next five years, which addresses points 1 and 2. As to what constitutes a 'substantial' ongoing need for non-growth capital investment is debatable. EnergyNorth Natural Gas, Inc. provided safe and reliable service prior to being acquired by National Grid in 2008 and it is unclear why capital expenditures have risen so drastically over the past few years and to what extent safety and reliability will be impacted by an additional investment of $63 million of non-growth related capital spending over the next five years. A certain level of capital spending is required to maintain a safe and reliable system, but given the current state of the economy customers may be better served by more conservative spending, spending, which when combined with the Company's projected sales growth, would make it possible for the Company to earn its authorized rate of return. Staff witness Knepper, Director of the Safety Division, testifies that reduced capital spending is not likely to harm system safety and reliability over the long run.

Lastly, Staff has used a year-end rate base to capture all test year investment and may be willing to support an annual step adjustment as part of a stay out provision that would allow for recovery on, and of, certain non-growth investments following a comprehensive review of those investments at that time.

Q. Why does Staff question the accumulated deferred income tax balance?

A. Although the balance included the Company's revenue requirement is consistent with what was reported in its last rate case and 2009 annual report, the Company's Schedule 3 – Deferred Income Tax (Exhibit EN 2-4, p. 4 of 5), includes a one line entry that reduces the balance by $32,572,501 and has a description that reads "Fixed Asset Study." It has been a topic of discovery but the Company has yet to provide an adequate explanation of that adjustment. Because the accumulated deferred income tax balance appears reasonable Staff has used that amount in calculating rate base and will seek further clarification and support regarding the Fixed Asset Study Adjustment. Staff reserves its right to file supplemental testimony with a revised revenue requirement related to this adjustment.

<u>Revenue Adjustments</u>

Q. What are Staff's revenue adjustments?

A. Staff made two revenue adjustments to reflect: (1) the increase in sales from residential non-heat customers switching to heating service; and (2) a full year of revenues for test year main and service extensions.

Q. What is amount of the revenue adjustments?

A. The total increase is $739,822, of which $70,384 is related to customers switching from non-heat to heat service and $669,438 related to test year main and service extensions.

Q. Does Staff normally adjust test year revenue related to test year plant additions?

A. No. Staff traditionally uses a 13-month average when determining rate base which properly weights rate base and test year revenue. Plant that is placed into service in the first month of the test year is reflected in 12 of the 13 months used to average test year rate base and will likely have generated almost a full twelve months of revenue during the test year. Conversely, plant placed into service in the last month of the test year will have generated no more than one month of test year revenue but will only be reflected in 1 of the 13 months used to average test year rate base.

Q. Why is it appropriate to adjust the revenue related to test year main and service installations?

A. Staff has used year end rate base, thereby reflecting the full cost of those installations in the rate base used to calculate the revenue requirement. Therefore, it is appropriate to reflect the incremental increase in annual revenue related to those test year capital investments.

Q. Has Staff adjusted the test year for all revenue producing capital investments?

A. No, Staff has only adjusted test year revenue for mains and services identified by the Company as revenue producing capital projects.

Q. Why only adjust revenue for test year main and service installations?

A. Test year plant additions that National Grid has identified as non-revenue producing should have no impact on test year revenue. For revenue producing projects other than mains and services, the impact on revenues is likely to be limited and not easily quantified. For instance, it is unclear how much revenue is produced by system reinforcement or when that revenue may be received. Main and service extensions, which make up the majority of the test year revenue producing capital investments, are only made if a minimum revenue requirement is met or exceeded per the terms of National Grid's tariff. National Grid operates under a

Commission approved main extension policy that ties investment cost to annual revenue, requiring a minimum margin of 25% of the capital cost from customer(s) to be served by the line extension, referred to as the '25% test.' Because of the revenue requirement spelled out in the tariff an annual minimum revenue increase can be quantified for main and service installations.

The additional revenues generated by test year revenue producing investments other than mains will serve to offset the cost of post test year plant additions that the Company has identified as non-revenue producing. While contrary to traditional ratemaking principals, Staff has deviated from those principals in this instance in recognition of the poor economy and the expectation that a turnaround may take some time.

Q. How did Staff calculate the amount of annual revenue related to the test year main and service installations?

A. Staff assumed that all growth investment in mains and services satisfies the 25% test, whereby projected revenue over the first four years must equal or exceed the capital cost, and calculated the additional revenue that would have been earned if the main and service installations had been in service for the full year and generated 25% of the capital cost. ***See Attachment SP-5.***

Q. How did Staff calculate the increase in revenue due to customers switching from non-heat to heating service?

A. The Company's response to OCA data request 2-83 provided the number of conversions during the test year and the 12 months following the test year, as well as the average increase per customer in base revenue from the conversions. Assuming test year conversions occurred equally throughout the test year, Staff adjusted test year revenue to reflect a full year of revenue related to the conversions. Staff included a full year of the revenue increase due to non-heat to heat conversions in the twelve months following the test year, as that is known and measurable. ***See Attachment SPF-6.***

<u>Expense Adjustments</u>

Q. What are Staff's expense adjustments?

A. Staff has decreased the expenses to remove advertising and promotional expenses, eliminate merger related costs, eliminate incentive pay tied to increases in earnings per share, reflect cost savings realized through cost savings initiatives undertaken by National Grid, reduce the bad debt expense as recommended and explained by Staff witness Bruce Gay, and reduce the pension, OPEB, Health and Hospitalization, and depreciation expense as recommended and explained by Staff witness James Cunningham. Expense adjustments are as follows:

Advertising & Promotional	($389,414)
Brand Conversion Project	($119,639)
Global ERP write-off	($95,633)
Incentive Pay	($181,679)
Saving from Saving Initiatives	($102,270)
Bad Debt	($44,372)
Pension & OPEB	($336,646)
Health & Hospitalization	($21,968)
Depreciation	($154,097)

Q. Please explain the advertising and promotional expense National Grid is seeking to recover through its proposed rates?

A. During the test year, National Grid ran an incentive program designed to convert non-gas customers to natural gas service by providing gas-fired boilers and other conversion equipment at a discount from retail prices. DR Staff 2-1. National Grid included one-half of the program's test year expense when calculating its proposed revenue requirement.

Q. Do Commission rules allow for recovery of advertising and promotional expenses?

A. Puc 510.03(a)(7) allows for recovery of advertising costs if "consistent with the utility's approved integrated resource plan," though Puc 510.03(d) states "no more than 50% of costs provided for in a utility's IRP shall be borne by ratepayers."

Q. Is the incentive program identified in National Grid's IRP?

A. No. National Grid's IRP filed in Docket No. DG 10-041 does not include any mention of the 'free boiler' incentive program or the role that program played in developing the demand forecast. The Commission has not yet ruled on the adequacy of the IRP in the pending docket.

Q. Does Staff have concerns regarding the 'Free Boiler' program?

A. Yes. The Commission does not normally encourage ratepayer-funded competition regarding the use of one energy source over another, and giving away free equipment to convert customers does that. Furthermore, the Company has not demonstrated that the program is cost effective.

Q. Did National Grid seek to include these costs in its last rate case?

A. Yes, and Staff objected based on the same arguments. In spite of Staff's concern as detailed in my testimony in that proceeding, the Company has continued the program and did not include, identify and describe the program in its IRP filing, nor did it provide an analysis of the cost effectiveness of the program.

Q. Should the cost of the 'free boiler' conversion incentive be eliminated?

A. Yes, for the reasons cited above. The Company included 50% of the test year program's costs, $389,414, in calculating its revenue requirement and Staff has made an expense adjustment to remove those costs.

Q. Please explain the merger related costs included in the Company's filing that should be eliminated.

A. National Grid's revenue requirement includes costs related to Brand Conversion and a Global Enterprise Resource Plan (ERP) write-off.

Q. Please explain the National Grid Brand Conversion.

A. During the test year National Grid spent approximately $4.4 million for Brand Conversion, of which $119,639 was charged to New Hampshire. The New Hampshire cost was for signage changes across National Grid's operating territory including changes to company operating facilities and vehicles.

Q. Does the Company consider Brand Conversion expenses a merger cost?

A. No. The Company is treating it as a test year operating expense, claiming the name change across all operating assets eliminates customer confusion and that use of a common name allows customers to benefit from the Company's educating customers on making smart energy decisions.

Q. Are Brand Conversion expenses a merger cost?

A. Yes, absent the merger there is no need for new signage. Furthermore, this is non-recurring expense and should not be used in setting future rates. Accordingly, Staff has reduced test year expenses by $119,639.

Q. Please explain the Global ERP write-off.

A. The ERP plan was a project designed to consolidate National Grid's front and back office into one global set of applications in the US and UK. At the end of calendar year 2008 National Grid decided that a regional solution was more appropriate and decided to write off the costs, of which $95,633 were charged off to New Hampshire during the test year.

Q. Should the ERP write-off be used in determining rates?

A. No. Similar to the Brand Conversion this expense would not occur absent the merger and it is non-recurring. Staff has reduced test year expense by the $95,633.

Q. Did National Grid pay bonuses during the test year?

A. Yes, during the test year both management and union employees received bonuses, referred to as incentive pay for non-union employees and gainsharing for union employees and a total of $457,675 was included in the Company's pro formed test year O&M expenses. Test year incentive pay charged to New Hampshire O&M totaled $663,197 of which $363,357 is included in the Company's revenue requirement. OCA 1-49. Test year gainsharing charged to New Hampshire totaled $104,633 of which $94,318 is included in the Company's revenue requirement. Staff Tech 3-29.

Q. How do employees earn bonus pay?

A. Bonuses are based on both financial targets and individual objectives. For non-union/management employees 50% to 60% of the maximum incentive compensation opportunity is based on financial targets and 40% to 50% is based on individual objectives. *See* DR Staff 1-67(a). Financial targets are set prior to the fiscal year and actual performance is measured at year end as a percentage of the target for each element. The same procedure is used to measure individual elements. The resulting percentages for each of the financial and individual elements are then added together and applied to the employee's eligible base pay earned during the year. *See* DR Staff 2-39. For non-union/management employees, the target rates for incentive compensation differ based upon their level within the organization. For union employees covered by the collective bargaining agreement, the target rates are contractual. *See* DR Staff 1-76. Company-wide earnings per share is a financial element common to all plans and no bonuses are paid unless that target is achieved. Other financial targets include operating cash flow and operating profits for the line of business in which the individual works.

Q. Did National Grid adjust its test year expense to remove bonus pay?

A. National Grid reduced the test year expense by $299,840 to eliminate test year incentive pay above the incentive pay target amount. The target amount is 45% of the maximum that could be earned if all objectives were fully achieved. The incentive pay target amount included in test year expense is $363,357. National Grid reduced the test year expense by $10,315 to eliminate test year gainsharing above the gainsharing target amount, leaving the target amount of $94,318 in test year expenses.

Q. Are all test year bonus payments reflected in O&M?

A. No, approximately 25% of bonus pay appears to have been capitalized (23% of incentive pay and 29% of gainsharing).

Q. Did the Company adjust rate base to remove capitalized bonus pay above the target amounts?

A. No.

Q. Does Staff agree that bonuses should be included at the target amount?

A. No. Staff has concerns with including bonus pay. There may be years in which targets are not met and there are no bonuses paid, yet those amounts would be recovered from ratepayers if included in the revenue requirement. In spite of that concern, if incentive pay is designed to provide a direct benefit to customers, and there is a reasonable expectation that it will be paid, then it may be appropriate to include some portion.

Q. How can one determine if target incentives provide a direct benefit to customers?

A. Individual objectives are based on job performance and therefore reward employees based on productivity. Rewarding highly productive employees for meeting and exceeding targeted goals benefits customers by improving overall productivity.

To what degree meeting financial objectives provides a direct benefit to customers, however, is debatable. Clearly earnings per share targets are a direct benefit to shareholders, as improved earnings per share means there are more funds available for stock dividends and upward pressure on stock prices. Customers may benefit through lower capital costs if the Company issues securities or long term debt. Only once in the last ten years has the Company sought Commission approval to issue securities or long-term debt and only then after the Commission opened an investigation into the Company exceeding its short-term debt limit. Thus, any potential benefit to customers is diminished. Other financial incentive target elements, such as line of business cash flows and profits, also appear to be more beneficial to shareholders than customers, as improved cash flow and profitability are more likely to enhance earnings per share than productivity.

Q. Does Staff have other concerns regarding the incentive pay tied to financial targets?

A. Yes, it appears that incentive pay tied to financial targets bears little or no relation to the

Company's performance in New Hampshire and may even be detrimental to New Hampshire. By National Grid's own accounting, its New Hampshire return has been well below its authorized return. In spite of the Company's poor financial performance in New Hampshire, the target incentives have been exceeded in each of the last three years. It would appear, therefore, that New Hampshire operations are not meeting financial targets, yet employee bonuses for meeting financial target are being charged to New Hampshire.

Setting a financial target of company-wide earnings per share may actually harm New Hampshire if it incents the Company to invest in other jurisdictions where there may be a greater opportunity to earn a higher return, rather than investing in New Hampshire projects that may offer a reasonable, if somewhat lower, return. National Grid operates in other jurisdictions where there may be a greater population density that enables the Company to add more load per line extension than in a more rural area such as New Hampshire. Operating costs, property taxes and authorized returns could all play a part in the Company's decisions to invest in jurisdictions other than New Hampshire in order to boost company-wide earnings per share. This benefits shareholders and employees at the expense of New Hampshire rate payers. Employees earn greater bonuses at the expense of customer growth in New Hampshire, which would enable to Company to spread fixed costs over a larger customer base.

If the Company does an outstanding job in New Hampshire and is able to achieve a high return, that return is likely to have negligible impact on company-wide earnings because New Hampshire represents such a small part of the business. Therefore, there is limited incentive for management to focus its attention on New Hampshire.

Q. What is Staff's recommendation regarding incentive pay?

A. Incentive pay tied to financial targets should not be included in test year expenses unless such pay can be demonstrated to result from a direct benefit to ratepayers. Because ratepayers may receive some benefit from the Company achieving its financial targets, Staff's recommendation is to allow recovery of the capitalized bonus pay and gainsharing target amounts but remove test year incentive pay tied to financial objectives and included in O&M expenses.

Q. How much of the test year incentive pay is tied to financial objectives?

A. Somewhere between 50 and 60 percent of the $363,357.

Q. What is Staff's adjustment to remove incentive pay based on financial objectives?

A. Staff reduced test year expense by $181,679, the minimum amount of the incentive pay based on financial objectives (50% of the incentive pay target amount paid during the test year).

Q. What adjustments were made as a result of National Grid savings initiatives?

A. Savings of $102,270 have been realized through the elimination of one full time position, discontinuing leases on a compressor and two trailers and restricting travel.

Q. Please explain the adjustment for the elimination of the position of one employee.

A. In November 2009 the Company eliminated an Administrative Assistant position with an annual salary of $49,350 and related benefits of $19,740 for a total annual savings of $69,090. DR Staff Tech 1-14.

Q. Please explain the adjustment for discontinuing compressor leases.

A. Two of three mobile compressors used in field operations were removed in August 2009, reducing annual lease expenses by $4,000. DR Staff 2-10.

Q. Please explain the adjustment for discontinuing trailer leases.

A. A closed box utility trailer and two towable digger trailers were removed from operations in August 2009 reducing annual lease payments by $7,000. DR Staff 2-10**.**

Q. Please explain the adjustment for travel restrictions.

A. Travel restrictions were endorsed by National Grid executives in January 2009 for immediate implementation. A comparison of U.S. travel expenditures between 2009 and 2008 shows a decrease of almost fifty percent. DR Staff 1-57(a)**.** Because the travel restrictions were not approved until the second half of the test year, the test year expenses have been adjusted to reflect a full year of travel restriction savings.

Q. What is the amount of the travel expense reduction and how was it calculated?

A. Test year expense was reduced by $22,180 based on a comparison of National Grid U.S. July 2008 through December 2008 with July 2009 through December 2009 travel expenses. That comparison was used to determine the percent reduction in travel expenses as a result of the travel restrictions. The percentage reduction was then applied to the July 2008 through December 2009 non-rate case travel expense included in the test year expense. DR Staff 1-57(a) and OCA 2-58(c) p. 2 of 3. ***See SPF-7.***

Q. What is the amount of the pension, OPEB, health and hospitalization and depreciation expense reduction as recommended by Mr. Cunningham?

A. The net impact on test year expense as a result of Mr. Cunningham's recommendations is an overall reduction of $220,437. The individual components are as follows:

Pension	$426,912
OPEB	($471,284)
Health & Hospitalization	($21,968)

Deprecation	($154,097)
Total	($220,437)

Q. Please explain Staff's adjustment to the bad debt expense.

A. Staff has reduced the bad debt expense to reflect what the expense would have been if the Company had utilized better collections practices, such as the ones they have proposed to implement going forward in addition to those suggested in Mr. Gay's testimony. Mr. Gay suggests three charge off percentages base on three scenarios, conservative, likely and aggressive. 2.06% is considered the likely scenario.

Q. What is National Grid's proposed bad debt percentage and annual expense?

A. 3.36% of total revenues for an annual expense of $5,518,477.

Q. What is Staff's proposed bad debt percentage and annual expense?

A. 2.06% of total revenues for an annual expense of $3,401,047.

Q. What is the amount of the reduction in bad debt expense?

A. The amount of the reduction in bad debt expense is $2,117,430, with $662,126 related to delivery revenues and $1,455,304 related to gas costs.

Recovery of Bad Debt Related to Gas Costs

Q. How is bad debt related to gas costs currently being treated?

A. Bad debt percentages were determined in the last delivery rate proceeding and are applied to annual gas costs and recovered through the COG. The partial settlement approved in the last proceeding reduces the percentage over four years in recognition of the fact that it would take time to implement the enhanced collections plan the Company intended to undertake and to realize the expected savings from improved collection practices. Actual bad debt experience varies from year to year but the bad debt percentages approved in the last delivery rate case remain in effect until a subsequent delivery rate case and Commission approval of a new percentage or recovery mechanism.

Q. What is the Company's proposal on how to treat bad debt write-offs related to gas costs?

A. Beginning with the November 2010 COG reconciliation the Company proposes to recover the actual gas cost-related monthly net write-offs instead of applying a fixed percentage against the actual monthly gas cost. (Leary testimony p. 16-17 of 23).

Q. Is it appropriate for the Company to recover the commodity related portion of its uncollectible accounts expense on a fully reconciling basis?

A. To the extent that accounts written off as uncollectible are beyond the Company's control it is appropriate. The Company's assertion by Mr. Stavropoulos (testimony p. 8 of 30) that since it has no opportunity to earn a profit on commodity sales it should not be at risk for non-collection of commodity-related revenue is reasonable, if one assumes that Company has taken all reasonable and prudent measures to recover those revenues. National Grid has not taken all reasonable and prudent measures as Mr. Gay explains in his testimony, therefore, a certain amount of the test year uncollectible write-offs were within the Company's control. It would be inappropriate to recover bad debt expense resulting from management's failure to minimize that expense, regardless of whether that expense is related to delivery or commodity revenue.

Q. How should bad debt related to gas costs be recovered?

A. Staff recommends actual bad debt related to gas costs beyond the Company's control be fully reconcilable and recovered through the COG.

Q. **How does one determine the bad debt expense within the Company's control?**

A. Mr. Gay has determined what the test year bad debt percentage would have been if the Company had better managed its collections process, which I will refer to as the theoretical bad debt. The amount of bad debt that was within the Company's control can be determined by taking the difference between the actual and the theoretical test year bad debt percentages, which is 1.30. The percentage difference between the actual and theoretical should be deducted from the actual bad debt experience related to gas costs to be recovered through the COG. Because the Company has plans to improve its collections practices to reduce bad debt, the difference between the actual and test year theoretical bad debt percentages should be compared prior to the COG filing and if there has been a reduction in the percentage differential, the actual percentage should be reduced by that differential. By way of example, the following three scenarios demonstrate the workings of this mechanism. First, if the actual bad debt percentage exceeds the test year bad debt percentage, the bad debt percentage applied to gas costs would be reduced by the difference between the test year actual and test year theoretical. Second, if the actual bad debt percentage is less than the test year bad debt percentage but exceeds the test year theoretical percentage, the bad debt percentage applied to gas costs would be reduced by the difference between the actual bad debt percentage and test year theoretical. Third, if the actual bad debt percentage is less than the test year theoretical bad debt percentage, the bad debt percentage applied to gas costs would be test year theoretical bad debt percentage.

If the actual bad debt percentage drops below 1.78%, the percentage achievable under Mr. Gay's aggressive scenario, the Company would only be allowed to add the difference between the theoretical (2.06%) and 1.78% to its actual bad debt percentage to be applied to gas revenues for collection through the cost of gas.

Q. Is it reasonable to use a test year theoretical bad debt percentage to determine the amount of bad debt that is within the Company's control?

A. Yes, it is reasonable given the time and expense it would take to perform an independent study of the Company's collections practices each year. Staff's proposal recognizes the Company's plans to improve collections and reduce bad debt by reducing the actual bad debt percentage by no more than the current differential between the actual and theoretical. If actual bad debt experience increases it is assumed that the increase is due to factors outside the Company's control. If the Company is able to reduce the bad debt percentage below the test year theoretical, Staff's proposal would allow the Company to collect the test year theoretical bad debt percentage as it assumes the reduction results from extraordinary collections practices and rewards the Company for its performance. If the Company exceeds what could be achieved under the aggressive scenario, then it is assumed other factors have contributed to the decrease in the bad debt.

<u>Excess Gas Supply Capacity Identified in Integrated Resource Plan</u>

Q. Please describe National Grid's IRP on file with Commission.

A. National Grid filed an IRP on March 1, 2010 (Docket No. DG 10-041) for the period November 1, 2010 through October 31, 2015, as required by Order No. 24,941 in Docket DG

06-105, pertaining to National Grid's prior IRP filing. Among other requirements, one is that the Company must describe its process for integrating demand-side and supply-side resources so that customer needs will be met at the lowest reasonable cost while maintaining reliability and taking into account other non-cost planning criteria.

Q. What is the status of IRP proceeding?

A. Staff has completed its review of the filing and on September 27, 2010, George R. McCluskey, Senior Analyst in the Electric Division, filed testimony regarding its review. On behalf of the parties in the docket, Staff filed a request for changes in the procedural schedule with Company rebuttal testimony due December 22, 2010 and a hearing on February 10, 2011.

Q. How do Mr. McCluskey's findings impact the immediate proceeding?

A. The IRP indicates that National Grid's supply portfolio far exceeds its requirements over the planning period and Mr. McCluskey has recommended the Commission open an investigation into how to address that situation. Mr. McCluskey suggests that retiring the peak shaving facilities, with the exception of those located in Tilton used to provide delivery service, would be the most cost effective way to eliminate excess capacity and has asked the Commission to open an investigation into the matter. It is imperative that the amount of the revenue requirement related to pressure support and recovered through delivery rates be properly identified. The remainder of the revenue requirement is related to providing supply and should be recognized as an indirect gas cost and recovered through commodity rates. What needs to be addressed in the immediate proceeding is the revenue requirement related to the Tilton peaking facilities that provides pressure support. The remainder of the revenue requirement will be reflected as an indirect gas cost and can be addressed in the first winter cost of gas proceeding following an investigation and decision as to which, if any, peaking facilities should be retired. Staff is attempting to determine what that amount should be, but just received the Company's response to is request on this matter (DR Staff Tech 3-18). Staff reserves its right to file supplement testimony on that matter.

Q. Is Staff proposing an adjustment to the indirect gas costs due to the excess capacity?

A. No. Based on Mr. McCluskey's testimony Staff believes that the peaking plants identified for retirement are no longer used and useful but is leaving the related costs in the revenue requirement pending a Commission decision in the IRP docket or subsequent investigation. Once a decision is rendered on the issue, the revenue requirement should be addressed in the subsequent winter COG proceeding, assuming an adjustment is required.

<u>National Grid Accounting Change</u>

Q. What is the accounting change and how does it impact rates?

A. Certain repairs by the Company had previously been capitalized for both regulatory and tax purposes, but are now being capitalized for regulatory purposes and expensed for tax purposes. The Company filed amended tax returns to realize the tax benefit of the accounting change going back a number of years. As a result there has been a substantial increase in deferred taxes.

Q. Has the IRS approved the accounting change?

A. No, but the IRS was notified by the Company of the accounting change and is expected to respond as part of its audit of the Company's tax return.

Q. What is likely outcome of the IRS review of this issue?

A. The Company expects the IRS will not accept the accounting exactly as applied in the Company's tax return and that there will be a difference in the tax paid and tax due as result, although the Company is confident that there will be no IRS penalties.

Q. How has the Company proposed to treat any additional taxes that might arise?

A. The Company has requested authorization to defer for future recovery the amount of any future adjustments or disallowance by the IRS for the Company's treatment of this item on its tax return, along with carrying charges at the weighted average cost of capital approved in this proceeding. If there are additional taxes, the Company would petition the Commission for an adjustment to rates for the rate base impact, and any adjustment approved by the Commission would be recovered through the Local Distribution Adjustment Charge (LDAC).

Q. What is Staff's recommendation regarding the proposed treatment?

A. Staff is supportive of the Company's proposal since the proposed rates reflect a reduced rate base due to the accounting change, which increases the accumulated deferred income taxes, thereby reducing customer rates. Shareholders will also benefit, as future tax savings resulting from the accounting change will offset the cost of future capital investments and result in higher returns. Staff recommends that the Company be allowed to defer the amount of any future adjustments or disallowances by the IRS related to the accounting change, but that the carrying charges should be at the Company's short term borrowing rate rather than the Company's weighted cost of capital. Since the Company is proposing to recover any IRS adjustment or disallowance through the LDAC, which is revised annually, any adjustment or disallowance would only be carried for a short period of time. Staff also recommends that if any IRS penalties are incurred as a result of the accounting change, those charges should not be allowed for recovery. The accounting change should not have been made if there is a risk of penalty, unless the Company is willing to hold customers harmless.

<u>Additional Concerns</u>

Q. Does the test year reflect a normal year?

A. No, the test year encompasses the world wide economic crisis and near meltdown of the financial system, a situation that contributed to a slowdown in National Grid's sales growth and increase in its bad debts. All else being equal, given that the recession appears to have ended, the Company's earnings should improve.

Q. Does the test year reflect some management inefficiencies?

A. Yes, management expected National Grid to realize net annual merger savings of $1.2 million and was confident enough in realizing those savings that it included a $0.6 credit to the revenue requirement in its last rate case. Not only did National Grid fail to realize the expected savings, the merger savings were not even enough to cover the annual amortization of the costs to achieve. The Company remains committed to achieving those savings (DR Staff 1-93) so it appears the problem is not in the savings forecast but is with management's implementation of the savings measures. Another area of concern is the Company's collection practices, as described by Mr. Gay. Incentive pay objects do not seem geared to holding down costs or encouraging customer growth. If incentive pay were tied to increasing the number of customers in New Hampshire, achieving that objective would benefit employees, customers and shareholders.

Q. **How would an improvement in the economy and management efficiency effect earnings?**

A. It Company would have much easier time in earning allowed rate of return.

Q. **How does the Company's proposal to increase its customer charge effect earnings?**

A. The Company will be better protected from a drop in earnings due to lower than expected sales. Currently the Company recovers approximately 41% of its fixed charges through the current customer charge and under the proposed customer charge 46% of fixed charges will be recovered through the customer charge. DR Staff 1-50.

Q. **Does that conclude your testimony?**

A. Yes.