STATE OF NEWHAMPSHIRE

PUBLIC UTILITIES COMMISSION

DG 10-017

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

Direct Testimony

of

Thomas C. Frantz
&
Mark A. Naylor

October 22, 2010

Q. Please state your names, occupation, and business address.

A. My name is Thomas C. Frantz. I am employed by the New Hampshire Public Utilities Commission as Director of the Electric Division. My business address is 21 S. Fruit St., Suite 10, Concord, New Hampshire 03301.

A. My name is Mark A. Naylor. I am employed by the New Hampshire Public Utilities Commission as Director of the Gas & Water Division. My business address is 21 S. Fruit St., Suite 10, Concord, New Hampshire 03301.

Q. Please summarize your education and professional experience.

A. Please see Attachments MAN-1 and TCF-1.

Q. What is the purpose of your testimony?

A. The purpose of this testimony is to provide Staff's position on the proposal of EnergyNorth Natural Gas, Inc. d/b/a National Grid NH (NG or the Company) to dramatically alter the way this Commission sets rates. For the reasons set forth in this testimony, Staff recommends that the Commission reject NG's proposal and recommends that the Commission continues to set utility rates by use of its traditional cost of service method.

Q. What is the ratemaking proposal requested by NG in this docket?

A. The Company proposes full revenue decoupling to remove the link between revenues and metered sales; an annual rate adjustment mechanism for pensions, other post-retirement benefit costs (OPEBs), and commodity-related bad debt; a proposal to modify its annual cast iron/bare steel (CIBS) rate adjustment mechanism to include public work projects and to eliminate the current annual threshold of $500,000 in expenditures prior to obtaining cost recovery; an inflation adjustment net of an assumed productivity factor of certain operating expenses; and an increase in the fixed customer charge designed to recover a greater percentage of NG's fixed costs through the customer charge. NG also proposes to use an end-of-year rate base (as of June 30, 2009) but updated for non-revenue producing assets put into service through the end of September, 2010.

Q. Please explain the ratemaking proposals put forth by NG in this docket, beginning with revenue decoupling.

A. NG's full revenue decoupling proposal would ensure that, regardless of NG's level of gas sales going forward, the company will be guaranteed receipt of the revenue requirement ultimately approved by the Commission in this docket. NG's revenue decoupling proposal is detailed in the testimony of Susan Tierney. In summary, a target revenue per customer will be established for each of three reconciliation groups for each season. To reconcile, actual billed revenue per customer will be compared to the target revenue, and the difference will be refunded or surcharged to each group. NG proposes that, if it were to acquire new customers subsequent to the establishment of its decoupling proposal, the revenues realized from those customers would not be a part of the decoupling reconciliation; NG would retain those revenues outside the process until its next rate case.

Q. What is the premise of NG's revenue decoupling proposal?

A. Both Ms. Tierney and Mr. Stavropoulos assert that NG has been unable to earn its authorized rate of return in recent years primarily due to the failure of the existing regulatory structure in New Hampshire, and the regulatory lag inherent therein, to address the challenges facing utilities today. NG asserts that these challenges include minimal growth and essentially flat gas usage per customer; the continuing need for capital investment that is non-revenue producing; and the volatility of certain costs such as pensions, post retirement benefits, uncollectible accounts, and property taxes. NG also cites the impact of energy efficiency efforts in reducing gas sales. From NG's response to Staff data request 1-18: "The traditional ratemaking process utilized by the Commission incorporates significant regulatory lag that makes it effectively impossible for a utility to earn its allowed return during periods of substantial ongoing capital investment, flat or declining commodity usage by customers and rising expenses."

Q. What does NG assert are the major benefits of a decoupling mechanism?

A. By eliminating the incentive for NG to expand its sales, NG asserts that its decoupling proposal will break the link between sales and revenues and ensure the financial health of the company. The company will be more assured of realizing its full revenue requirement and, therefore, be more assured of realizing its authorized rate of return. This enhanced financial performance will in turn facilitate NG's access to the capital it needs in operating its system and in improving the system's reliability.

Q. Please briefly describe the reconciling mechanisms NG proposes.

A. NG proposes an annual rate adjustment mechanism for pension costs, OPEBs, and commodity related bad debt (also known as "cost trackers"). NG also requests an inflation adjustment net of an assumed productivity factor of certain operating expenses. For the annual rate adjustment mechanisms, the test year amounts would be included in base rates, and NG would subsequently defer changes in those costs until reconciliation occurs in its LDAC filing. The inflation adjustment would be applied to certain of NG's operating expenses affected by inflationary pressures. It would include a fixed productivity offset based on industry-level productivity.

Q. Please indicate why Staff opposes NG's proposal to alter how this Commission sets rates.

A. There is one overriding reason why Staff opposes NG's proposal: it inappropriately shifts a substantial amount of the company's operating risk to customers.

Q. Please explain how NG's proposal shifts a substantial amount of the company's operating risk to customers.

A. Traditional cost of service ratemaking has been in place for decades, and is based on the actual costs a utility incurs to provide service. Contrary to the assertions of NG, it is not a system that is broken. Current ratemaking practice already contains measures to protect the utility from volatility in certain costs, including twice-annual adjustments to rates to reflect changes in commodity costs, adjustments to rates through the CIBS program, and recovery of other costs through the Local Distribution Adjustment Charge (LDAC). NG now asks that it be shielded from the vagaries of changes in sales volumes by implementing decoupling. It asks that the normal operating risk of changes in certain costs be removed by tracking those costs annually and being granted full recovery. It asks for an annual adjustment for the impact of inflation on its costs. This is how NG would shift its operating risk to customers.

Q. Why do you believe that this shifting of risk is inappropriate?

A. That NG claims to be unable to achieve its allowed rate of return is not a reason to ask customers to assume more risk. Traditional ratemaking provides a utility an *opportunity* to earn its allowed rate of return; that return is not and should never be seen as an entitlement. In addition, since traditional ratemaking substitutes for a competitive market, utilities should not be shielded from the effects of current economic conditions. NG's decoupling proposal would ensure the Company receives virtually every penny of its established revenue requirement; it is a revenue assurance mechanism[1]. It is inappropriate and potentially harmful to customers to assure a utility of its revenue requirement following a rate case. To do so removes a portion of the important incentive of utility management to make intelligent decisions in areas such as capital spending and cost containment. Add to that the protection NG would receive by being able to adjust substantial portions of its operating costs in rates annually, and customers assume even more risk. NG states that it needs this proposal to remain financially healthy and maintain access to capital. Staff would respond that customers have a right to a financially healthy utility already, and rates established under the existing regulatory regime provide that opportunity to the utility. If prevailing economic conditions have contributed to the company's reduction in overall earnings, the company has an obligation to review its own operations first, including its budget

[1] That NG proposes to retain all revenues from new customer accounts established subsequent to the implementation of decoupling, as referenced earlier, would mean NG could realize revenues in excess of the revenue requirement approved in this case.

for capital expenditures, as detailed in the testimony of Staff witness Knepper. It has yet to realize merger savings, as mentioned in the testimony of Staff witness Frink. It is fundamentally unfair and inappropriate to make customers the "last resort" for the utility.

Q. What other concerns do you have with respect to NG's proposal?

A. Companies that have been granted a monopoly franchise to provide utility service are substantially free of competitive pressures that, in unregulated businesses, help to ensure that those companies strive to enhance performance. Traditionally, it is the responsibility of utility management to cope with normal business trends and economic forces. NG's proposal would result in a fundamental change in ratemaking philosophy since it would absolve management of a significant portion of the risk associated with normal operations, and shift that risk to customers. Customers do not benefit from this shift, and may be harmed.

Another concern we have with NG's proposal is that it would substantially eliminate any regulatory lag inherent in the ratemaking process. Regulatory lag provides the incentive to appropriately manage costs. As noted by Alfred Kahn,

> Freezing rates for the period of the lag imposes penalties for inefficiency, excessive conservatism, and wrong guesses, and offers rewards for their opposites; companies can for a time keep the higher profits they reap from a superior performance and have to suffer the losses from a poor one[2].

In addition to these factors, this Commission has previously rejected rate reconciling mechanisms as being inconsistent with normal accounting procedures. See *Unitil Energy Systems, Inc.*,Order No. 24,449, 90 NH PUC 133 (2005). As for NG's proposed inflation adjustment, it is not based on actual cost incurred by

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[2] Alfred E. Kahn, *Economics of Regulation, Vol. 2* (New York: John Wiley & Sons, 1971), 48.

the utility but instead based on a formula. For that reason alone it should be rejected.

Q. NG asserts that customers will still have the opportunity to manage their energy bills under its proposal. Do you agree?

A. Only in the sense that a reduction in the amount of gas used will result in a lower bill for the energy portion of the bill. A rational consumer is going to do what is best for him or her. It is reasonable to expect that a consumer will conserve. Under NG's proposal, however, we are limiting the consumer's ability to manage his or her finances. This is counter-intuitive to the premise of economic regulation. The purpose of economic regulation is to mirror the actions of competitive forces that would be placed on a company in a market environment, and companies operating in that market environment are not insulated from changes in economic conditions.

Q. What about the argument that decoupling revenues from sales eliminates the disincentive on the part of the utility to aggressively promote energy conservation?

A. If decoupling de-links revenues from sales, then decoupling de-links the consumer from making his or her own decisions about energy consumption. And just because an action may reduce the Company's disincentive to promote conservation, it does not necessarily make that action desirable in a broader context. Further, NG has not proffered this proposal on the basis that it will undertake even greater efforts to promote energy efficiency and conservation.

Q. The company has indicated that, absent approval of its rate proposal, it is likely that it will need to file "far more frequent" rate cases in the future. What is the Staff's position regarding this statement?

A. To Staff, filing rate cases are a far more preferable way to proceed in the future than to simply guarantee the company its revenue requirement and shift most of the utility's operating risk to its customers. In recessionary economic environments such as the present, more frequent rate proceedings would not be unexpected anyway since slower economic growth and changing utility costs may not be offset by customer growth as they might be in a stronger economy. Occasional rate cases are an essential element for effective regulation since other factors may need to be reviewed such as the cost of capital and rate design. Rate cases also allow regulators to review costs closely for improper accounting and allocations. The stated intention to file more frequent rate cases should never be construed as an effective threat to receive the regulatory treatment the utility seeks. In New Hampshire, a utility can file a rate case whenever it can demonstrate an earnings deficiency. The Commission always has the option to deny rate case expenses in the event that earnings deficiency does not materialize on closer scrutiny.

Q. Does this conclude your testimony?

A. Yes it does.

EDUCATION AND WORK EXPERIENCE OF MARK A. NAYLOR

My educational achievements include a Bachelor of Science degree in Social Science from Plymouth State College in 1978, and a Master of Science degree in Accounting from New Hampshire College in 1985.

I completed the National Association of Regulatory Utility Commissioners (NARUC) Annual Regulatory Studies Program at Lansing, Michigan in August of 1992, and I completed the Nineteenth Annual Eastern Utility Rate Seminar co-sponsored by NARUC, the Florida Public Service Commission and the University of Utah in Hollywood, Florida in October of 1991. I am a member of the NARUC Staff Subcommittee on Accounting and Finance.

My professional work experience began as a Planner working for the Central New Hampshire Regional Planning Commission and the City of Manchester during the years from 1978 to 1984. Upon receiving my MS in 1985, I was hired by Foxhill Interiors, Inc. in Bedford, NH as Controller. There I was responsible for all accounting, administrative, and financial functions of the Company. In October of 1986 I joined Landmark Title, Inc. in Manchester, NH as Controller. In this position I assumed responsibility for the accounting and finance functions of the Company and its two start-up subsidiaries, including preparation of financial statements and tax returns, budgeting and forecasting, and internal reporting to the parent company in Houston, Texas. I was named a Vice President by the Company Board of Directors in 1987.

In November of 1990 I joined the Finance Department of the New Hampshire Public Utilities Commission as a PUC Examiner. In that capacity I worked primarily on water and wastewater utility matters. I participated in Staff audits, conducted financial analysis and prepared written testimony, and testified in those cases before the Commission. I was promoted to Assistant Finance Director in August of 1995. In January of 1998 I was named Acting Finance Director, and in August of that year was promoted to Finance Director. My responsibilities in that position included management of the Finance Department and review and approval of the Department's work products, review of financial statements and earnings levels of the regulated utilities, and providing advice and testimony on revenue requirements, earnings levels, financings, accounting and related matters to the Commissioners, department heads, regulated utilities, and the general public. Following a reorganization of the Commission's Staff in late 2001, I was named Director of the Gas & Water Division. In that capacity I manage and direct the Staff of that division, and am responsible for Staff involvement in all dockets concerning gas, water, sewer and steam utilities that are pending before the Commission.

ATTACHMENT

TCF-1

EDUCATION AND WORK EXPERIENCE OF THOMAS C. FRANTZ

I received a B.S. degree from the Pennsylvania State University in Environmental Resource Management and completed all course work and research for a M.S. degree in Resource Economics from the University of New Hampshire. My graduate research involved modeling the structure of the New Hampshire economy using an input-output analysis. I have taught college courses in macroeconomics, microeconomics and managerial economics.

I started work at the Commission in 1989 as a staff economist. My work focused primarily on fuel price forecasting and the analysis of economic forecasts. In 1990, I was promoted to Utility Analyst III. My responsibilities concentrated on electric utility issues including analyzing and advising the Commission on cost of capital, rate design, special contract, and fuel and purchased power adjustment clause filings.

In January 1996, I was promoted to the position of Chief Economist. My new responsibilities included administering the Economics Department’s research and analysis of economic and utility matters, as well as providing the Commission with expert testimony and advice on economic, utility and public policy issues. My responsibilities also included testifying before the Legislature on utility matters.

The Commission reorganized in late 2001 and I was named Director of the Electric Division. As Director of the Electric Division, I am responsible for the case management of the electric proceedings before the Commission including the day-to-day work of the Staff of the Electric Division. I also continue to provide the Commission and, when requested, the Legislature with advice on electric utility matters.