STATE OF NEW HAMPSHIRE
BEFORE THE
PUBLIC UTILITIES COMMISSION

EnergyNorth Natural Gas, Inc. d/b/a National Grid NH
Docket No. DG 10-017

Rebuttal Testimony
of
Frank Lombardo

December 7, 2010

TABLE OF CONTENTS

I. Updated Revenue Deficiency Calculation........1
II. Response to Revenue Requirement Adjustments Proposed by Staff........5
- **A. Rate Base Adjustments**........5
- **B. Operating Expenses**........9
  - **1. Incentive Compensation**........9
  - **2. Advertising Expense**........15
  - **3. Implementation of Cost Saving Measures**........16
  - **4. Bad Debt Adjustment**........17
  - **5. Pension/OPEB**........18
  - **6. Depreciation**........19

III. Response to Adjustments by OCA........20
- **A. Contract Center Consolidation**........21
- **B. Normalizing Adjustments**........23
- **C. Health and Welfare Benefits**........24
- **D. Postage**........25
- **E. Office Supplies**........25
- **F. Collections Expense**........26

IV. Pension/OPEB Reconciling Mechanism........27

Attachment FL-R1
Attachment FL-R2
Attachment FL-R3
Attachment FL-R4
Attachment FL-R5
Attachment FL-R6
Attachment FL-R7
Attachment FL-R8
Attachment FL-R9
Attachment FL-R10
Attachment FL-R11
Attachment FL-R12

Q. Please state your name and the purpose of your rebuttal testimony.

A. My name is Frank Lombardo. I previously submitted written direct testimony jointly with Michael Adams in this case on behalf of EnergyNorth Natural Gas, Inc. d/b/a National Grid NH ("the Company") on February 26, 2010. I am submitting this rebuttal testimony to present the Company's updated revenue deficiency calculation and to respond to a number of positions set forth in the testimony of Stephen Frink ("Mr. Frink") and James Cunningham ("Mr. Cunningham") of the Public Utilities Commission staff ("Staff") and Kenneth Traum ("Mr. Traum") of the Office of Consumer Advocate ("OCA").

I. Updated Revenue Deficiency Calculation

Q. You indicated that the Company has updated its revenue deficiency calculation. Please explain why it has done that.

A. Through my direct testimony and that of Dr. Susan Tierney, the Company explained the impact of regulatory lag on its ability to earn its authorized rate of return in an environment where the Company finds itself making substantial non-growth related investments in its distribution system but use per customer is flat or declining. The combination of these factors makes it effectively impossible for the Company to earn its allowed return when a test year rate base is used to set rates for a future period. To address this problem, the Company proposed to update its rate base for purposes of setting rates to a period that is close as possible to the hearing date in the case. The Company's original filing included a forecast of non-growth capital through September 2010, with the stated intention of revising the filing once actual data was available. The

Staff used a June 2009 rate base figure in its testimony, and, rather than continue to litigate the Company's original proposal to use a September 2010 rate base figure because it would be closer in time to the conclusion of this case, the Company has adopted a test year end rate base figure as well.

Q. In calculating the updated revenue deficiency, what items did you update from the Company's original filing?

A. The Company's updated revenue deficiency calculation is included with this testimony as Attachment FL-R1. The items that were updated are listed below. This calculation and the attached exhibits are similar to the update that was provided to Staff and the parties in discovery in the Company's supplemental response to OCA 1-73, but among other things I have used a June 2009 rate base (i.e., I excluded any adjustment for non-growth capital beyond the end of the test year) and incorporated Mr. Hevert's updated return on equity. I have also made adjustments for a number of items where there is full or partial agreement with items identified by Staff or the OCA. With that explanation, the update reflects the following changes from the initial filing:

- Rate base was adjusted to remove non-growth capital for the period July 1, 2009 through September 30, 2010.
- Accumulated depreciation was updated to exclude depreciation on the new non-growth capital and continued depreciation (i.e., after the test year) of capital in service as of June 30, 2009.

- Working capital has been updated for the lead lag study prepared by Mr. Normand (and filed on April 23, 2010) after the original filing was submitted.
- Operating expense was reduced to reflect the changes agreed to by the Company during the course of the Staff's audit and discovery by Staff and the parties.
- Property taxes were adjusted to reflect tax increases in the City of Concord as of February 2010 (an increase of $152,646)
- The return on equity was updated to reflect the 10.75 percent return recommended by Mr. Hevert in his rebuttal testimony. Because the Staff's cost of equity witness did not support a stay-out premium, the Company is no longer proposing a stay-out period and therefore the addition of 20 basis points to reflect the additional risk associated with such a proposal is not reflected in the Company's updated proposal.
- In response to an adjustment proposed in Mr. Frink's testimony, the Company has increased test year revenues by $297,936 (as opposed to Staff's proposal of $739,822).
- The Company has increased insurance expense by $120,870, consistent with its response to Data Request Staff Tech 1-17, which is included with this testimony as Attachment FL-R2.
- In response to Mr. Frink's and Mr. Traum's testimony, test year operating expenses were reduced for the following items:
    - Elimination of one full time position, discontinuing leases on a compressor and two trailers - $80,090

- Health & Hospitalization - $37,688
- Brand Conversion Project - $119,639
- Global ERP write-off - $95,633

- Consistent with Staff's recommendation, the Company has updated its deferred tax position as of June 2009, added a $600,000 pro-rata (based on time) portion of benefit of the tax repair change I discussed in my direct testimony and a $1,125,000 pro-rata adjustment for the fixed asset study that I discuss in this rebuttal testimony.
- The Company removed $46,000 related to the replevin process – originally included as a component of the $776, 886 in credit and collections program changes.
- Finally, the Company has updated its depreciation expense as originally set forth in Exhibit 2-2-4 to remove the estimated depreciation expense on non growth capital originally filed at $150,925.

Q. What is the impact of the updated revenue deficiency calculation on the Company's rate filing?

A. The updated revenue requirement, shown in Attachment FL-R1, results in a revised revenue deficiency of approximately $9.7 million, as compared to $11.4 million in the Company's original filing.

II. Response to Revenue Requirement Adjustments Proposed by Staff

Q. In Mr. Frink's and Mr. Cunningham's testimonies, the Staff recommended a number of adjustments to the Company's revenue requirement. Are there any adjustments that you disagree with?

A. Yes. The Company disagrees with a number of the proposed adjustments. I will generally address the adjustments relating to rate base and operating expenses. Ms. Leary's testimony addresses the adjustment proposed by Mr. Frink relating to the Company's operating revenues.

A. Rate Base Adjustments

Q. What is your response to the rate base figure proposed by Mr. Frink?

A. Mr. Frink's testimony proposed that the Commission use a test year end (i.e., June 30, 2009) figure for rate base. The Company concurs with Staff's position on rate base and has updated its revenue requirement resulting in a rate base of $167,171,345. The Company recognizes that Staff's position is a significant variation from standard Commission practice and very much appreciates their willingness to be flexible on this issue.

In his testimony, Mr. Frink proposed a rate base figure of $167,670,003 for June 30, 2009 test year end , rather than the $169,006,099 amount in the Company's original filing, which included estimated non- growth capital. Based on Mr. Frink's response to Data Request NG-Staff 1-64, a copy of which is attached as Attachment FL-R3, it is the

Company's understanding that Staff's revised rate base figure, utilizing end of period June 2009 rate base, is $168,919,824 which compares to the Company's revised rate base of $167,171,345 (after updating for a $600,000 pro-rata (based on time) portion of the increased deferred taxes resulting from the tax repair change I discussed in my direct testimony and a $1,125,000 pro-rata adjustment for the fixed asset study that I discuss later in my rebuttal testimony). Both of these items act as a reduction to rate base.

Q. Does the Company have a response to the Staff's position on the level of deferred taxes that is appropriate to include in the determination of the Company's net rate base for purposes of ratemaking?

A. Yes. The Company agrees with the Staff's calculation of the level of deferred taxes, as it relates to the repairs tax change, to be reflected for purposes of determining rate base as of June 30, 2009, but that agreement is contingent on the Company's understanding that Staff supports implementing an adjustment mechanism through the Company's local distribution adjustment charge in the future if some portion of those deferred taxes must be paid currently (including with interest) as the result of a settlement with or ruling by the Internal Revenue Service. It is the Company's understanding based on Staff's response to Data Request NG-Staff 1-66 that that is the case. A copy of Staff's response is attached as Attachment FL-R4. Separate and apart from that adjustment, the Company has updated its deferred tax position for the impact of the fixed asset study that I discuss below.

Q. Mr. Frink also indicated that he was seeking a clearer understanding of the impact of the fixed asset study conducted by the Company on the level of rate base. Mr. Traum expressed a similar concern on behalf of the OCA. What information can you provide related to that study?

A. The fixed asset study was conducted in connection with National Grid's acquisition of KeySpan Corporation and its affiliates, including EnergyNorth Natural Gas, Inc. This kind of study is commonly conducted by companies that have gone through a merger or other major acquisition and is intended to ensure the accuracy of the accounts being audited by the Company's external auditors and that they conform to purchase accounting rules that require the Company's assets and liabilities (including tax assets and liabilities) be set at their appropriate values. The study verifies the accuracy of the inherited income tax accounting records by conducting a historical review of depreciation claims and reconstructing income tax accounting records as appropriate. In this case, the study generally confirmed the accuracy of the Company's records, but resulted in a small increase ($4.5 million) to the level of deferred taxes reflected on the Company's books. Because of the timing of the study relative to the filing of National Grid's tax return, however, the adjustment is actually reflected in the form of a $32.5 million estimated increase in deferred taxes that was booked in December 2009 followed by a reversal of approximately $28 million in March 2010.

Q. Why did the Company first book an estimate and then reverse a significant portion of that estimate?

A. The Company is required to file with the IRS its fiscal year-end (i.e., March 31) corporate income tax return by June 15 each year. Thus, the tax return for the fiscal year ending March 31, 2009 was due June15, 2009. The IRS allows an automatic six months extension for corporate income tax returns, and therefore the filing of the Company's fiscal 2009 return was extended six months to December 15, 2009. The fixed asset study was completed in 2009, and therefore National Grid was required to reflect the results in its 2009 income tax return. At the time of the filing, National Grid had not yet completed the process of determining the proper allocation to its various subsidiaries of the adjustments arising from the fixed asset study. In accordance with the Company's accounting policies, it was required to book an allocation to its subsidiaries within fifteen days of filing its tax return. In order to meet this requirement, the Company estimated the amounts to be booked for each subsidiary. For National Grid NH, that estimate was an increase of $32.5 million in deferred taxes. In early 2010, the Company then finalized the allocations and determined that the proper allocation for National Grid NH was an increase of $4.5 million, not $32.5 million. To reflect this on the books of the Company, a reversing entry of $28 million was made. These types of accounting entries (called true-ups) are a normal and expected part of the income tax process as described in the Company's accounting policies. Thus the final outcome of the study was a net reduction in rate base of $4.5 million, of which, a pro-rata portion has been included in the end of period June 2009 deferred tax amount in the Company's rate base included in the revised revenue requirement. The prorated portion was determined using the same methodology used by Staff to prorate the deferred tax adjustment for the tax repair change.

B. Operating Expenses

Q. Are there operating expense adjustments proposed by Staff that the Company disagrees with?

A. Yes. Of the adjustments (or categories of adjustments) that the Staff has proposed, the Company disagrees with the following:

- Incentive Compensation--$181,679
- Advertising and Promotional--$389,414
- Savings from Saving Initiatives-- restricting travel--$22,180
- Bad Debt--$2,117,470
- Pension and OPEB--$44,372

1. Incentive Compensation

Q. Please explain why you believe Mr. Frink erred in reducing the Company's operating expenses by $181,679 for a portion of the Company's incentive compensation program.

A. Simply put, the level of total compensation paid by the Company is competitive with what is paid by other employers in the market. It is reasonable, has been prudently incurred and, therefore, it is appropriate to include as an operating expense for ratemaking purposes. Mr. Frink's analysis mistakenly focuses on the manner in which total compensation is determined, rather than the amount itself. Moreover, even if one considers the way in which the Company's compensation system has been designed, there are sound business reasons for the Company's decision to include incentive compensation as a significant component of how it pays its employees for their performance. Although Mr. Frink's critique may be well-intentioned, it really amounts to an invitation to the Commission effectively to micromanage National Grid's business operations and limit its managerial discretion in a way that is not appropriate. If the Company's salary structure results in reasonable costs, the Company should be allowed some discretion to determine how best to structure that compensation.

Q. You indicated that the overall level of compensation is competitive with the market and is reasonable. What is the basis for that statement?

A. National Grid regularly surveys the marketplace to determine the level of pay and benefits that it needs to provide to attract and retain qualified employees. Those surveys form the basis of the compensation and benefit levels that the Company offers both its union and non-union employees. The compensation levels that the Company uses for comparison purposes are not the base compensation that it pays, but rather the total compensation, including all components of incentive compensation paid out at target levels. If the Company were to follow Mr. Frink's guidance, it would effectively have two choices—either reduce compensation by eliminating the incentive compensation portion that Mr. Frink is proposing to remove from the Company's revenue requirement or gross up employees' base pay to include the amount that is currently paid under the incentive compensation program that is attributable to achievement of financial targets.

Q. What would happen if the Company followed either of those strategies?

A. The first would not be viable, and the second would be counterproductive.

Q. Please explain what you mean.

A. As I noted earlier, the Company's compensation is designed to be competitive with other employers, assuming that incentive compensation is paid out at the target amount. If National Grid changed its compensation program by eliminating the portion of incentive compensation relating to achieving financial targets, pay levels would be below market and, the Company would no longer be competitive and would find it extremely difficult to attract and retain qualified employees. Such a result would be very damaging to the Company and its customers. If, instead, the Company were to gross up base pay to include the portion that is attributable to attaining financial targets, compensation levels would be the same as they are today and there would be no impact on rates, but the Company would be deprived of an important tool that it uses to attempt to meet the expectations of shareholders and the capital markets, i.e., achieving its earnings targets.

Q. Why should the Commission be concerned about whether National Grid is able to achieve its earnings targets?

A. Consistent failure to meet shareholder expectations will result in lower stock prices, lower credit ratings and, ultimately a higher cost of both debt and equity capital. In turn, not only will the Company's cost of capital (and, therefore, rates) increase, but it will also lead to further limitations on the extent to which the Company can invest capital in its distribution system and could cause the Company to restrict its operating expenses in ways that adversely impact customer service and satisfaction. Simply put, National Grid's ability to achieve its earnings targets is in the interests of both shareholders and customers. As a highly capital intensive business, the Company needs a ready source of efficient capital. Its best hope of securing that capital at lowest cost is to be strong financially and capable of generating strong performance over long periods of time. Since these outcomes are so critical to the Company's business and customers, it is appropriate that employees' annual pay be connected to business results.

Q. Do you have any other concerns about eliminating the achievement of financial targets from the incentive compensation structure?

A. Yes. I recognize that Mr. Frink's criticism of the Company's incentive compensation structure related only to the portion that is tied to achieving financial targets, not the portion that is tied to each employee achieving his or her personal, job-specific objectives. However, in this day and age, it is highly questionable whether shareholders would support and whether the public would condone, payment of incentive compensation at times when a company is not meeting some basic financial metrics. One only need pick up a newspaper to see the public condemnation that has been directed toward companies that have found themselves paying large bonuses to employees of companies that had little or no earnings. The inclusion of financial targets in the incentive compensation system ensures that this portion of the overall compensation package reflects the overall company performance as well as individual achievements and helps ensure that employees work collaboratively as a team to enhance performance and achieve business objectives, rather than solely focusing on their own personal objectives.

Q. But Mr. Frink points out that National Grid NH has not been achieving its earnings goals and yet the Company is including incentive compensation in its revenue requirement. How do you respond?

A. First, I should note that the majority of the employees whose compensation is included in the revenue requirement are employed by National Grid's service companies, not by National Grid NH, and therefore they provide service to many parts of the National Grid family of companies. They have little ability to directly affect National Grid NH's earnings.

Second, achieving cost savings, increasing productivity and enhancing efficiency are some of the most important means of maintaining and improving earnings—all of which benefit customers, not just shareholders. In many circumstances, revenue increases benefit customers as well. Financial targets are not achieved in a vacuum. They are attained by operating the company in a manner that benefits both customers and shareholders. One only need to consider some of the ways in which management works to achieve earnings targets to appreciate this—this includes everything from improving procurement processes to reduce costs, finding opportunities to restructure the

Company's capitalization, improving billing processes, negotiating volume purchasing arrangements, and many, many more areas.

Third, the financial target portion of the incentive compensation program works more as a brake on incentive compensation when the Company is underperforming than it does as a separate basis for generating additional compensation. By that I mean that the central component of the program provides for an employee to earn a particular level of incentive compensation based on his or her achievement of personal objectives related to his or her specific job. If National Grid fails to achieve at least a certain basic level of earnings, then no incentive compensation is paid at all. If the targeted level of earnings is achieved, then the targeted amount of incentive compensation is paid. If an intermediate level of earnings is achieved, then an intermediate level of incentive compensation is paid. On the other hand, if an employee fails to achieve his or her individual performance targets, they will not be paid at targeted levels and will receive less incentive compensation.

Finally, the use of incentive compensation arrangements that include financial targets is extremely common among major employers today, and removing such a management tool from National Grid would put it well outside the main stream. Eliminating incentive compensation (or even a significant portion of it) would turn back the clock to a time when employees' pay had little or no connection to performance. In those days, fixed payroll costs were high and most employees saw no tangible reason to change their work practices or contributions to improve the performance of their employer. The Company sees nothing constructive in such an approach. To the contrary, the Company fundamentally believes that (1) such a direct connection is vital to its ability to deliver on key performance indicators and the sustained improvement of that performance and (2) both customers and shareholders have historically benefited from this practice.

2. Advertising Expense

Q. Mr. Frink proposes to reduce operating expense by $389,414 to eliminate promotional and advertising expense. What is the Company's response?

A. The Company strongly disagrees with this proposed adjustment. In fact, Mr. Knepper's testimony for Staff takes the Company to task for what he claims is insufficient effort in the area of sales and marketing. Expansion of the Company's load through the addition of new customers is beneficial to the Company's existing customers, and in fact, it is the difficulty that the Company has faced in increasing its load that is a primary driver of the increased frequency of rate cases. The Company explicitly articulated the need for sales and marketing efforts in its current IRP and those efforts have been the subject of discussion in prior IRPs as well. The Company not only believes that it has included these expenditures in its revenue requirement on a basis that is consistent with the PUC regulation referred to by Mr. Frink, it also believes that the continuation of the programs supported by this expense is a critical component of its efforts to achieve a measure of rate stability for the Company's customer base. As Mr. Knepper's testimony plainly suggests, effective sales and marketing efforts are a necessary component to enable the Company to have a meaningful opportunity to achieve its authorized rate of return. In the absence of such efforts, it is hard to imagine how the Company will ever earn that return, given the high proportion of non-growth related investment it faces each year. Yet, if funding for the Company's sales and marketing efforts is removed from its revenue requirement, it is unrealistic to expect that the Company will be in a position to continue those programs.

3. Implementation of Cost Saving Measures

Q. Mr. Frink proposed reductions totaling $102,270 in the Company's operating expense for cost reductions that the Company has indicated it believes it can achieve from ongoing efforts to achieve cost savings. What is the Company's response to his proposed reductions?

A. Of Staff's proposed $102,270 in reductions, the Company accepts Staff's proposed adjustments totalling $80,090 relating to the elimination of the full time position and discontinuance of the leases for the compressor and trailers. Those savings have been attained and therefore are now known and measurable. The Company, however, disagrees with the reduction for travel restrictions in the amount of $22,080.

Q. Why does the Company disagree with Staff's position on travel restrictions?

A. Staff's testimony correctly notes that travel restrictions were endorsed by National Grid executives in January 2009 for immediate implementation. While the restrictions were implemented with the goal of reducing overall expense, the only thing that is known is that they will result in travel expense being lower than they otherwise would have been on a going-forward basis. That does not mean, however, that travel expense will actually be lower, and such a conclusion is wholly speculative. Obviously, the Company's travel needs vary from year to year, so the actual impact of the restrictions cannot be known in advance. In addition, and equally important, the travel restrictions were in effect for the second half of the test year (i.e., January –June 2009), so to that extent the impact of the restrictions is already fully reflected in the test year data.

4. Bad Debt Adjustment

Q. Mr. Frink also recommended that both the Company's delivery and commodity-related uncollectible accounts expenses be adjusted. What is the Company's position with regard to these expenses?

A. The issue of uncollectible accounts expense is addressed in the rebuttal testimony of Ms. McCarthy and Mr. Hirschey. In summary, the Company continues to believe that (1) it is appropriate to use the test year level of uncollectible accounts expense to determine base rates and (2) commodity-related uncollectible accounts should be fully reconcilable. The Company appreciates that both Mr. Frink for Staff and Mr. Traum for the OCA have indicated that they support reconciliation of commodity-related uncollectible accounts expenses, but the Company emphatically disagrees with Staff's proposal to disallow a portion of that expense based on the criticisms leveled by Mr. Gay in his testimony. Ms. McCarthy and Mr. Hirschey will address Mr. Gay's testimony in detail.

5. Pension/OPEB

Q. What is the Company's disagreement with Staff's proposal regarding pension and OPEB expense?

A. First, the Company continues to believe that the large size of these expenses and their volatility warrant the adoption of a reconciling mechanism to protect both the Company and its customers. I will address this issue in detail in Section IV of this testimony. Second, even if a reconciling mechanism were not adopted, Mr. Cunningham incorrectly determined the level of annual pension and OPEB expense apparently because of a misunderstanding during the discovery process. Specifically, Mr. Cunningham recommended a net reduction of $44,372 for pension and OPEB expense, which is made up of an increase of $426,912 for pension expense and a decrease of $471,284 for OPEB expense. Attached as Attachments FL-R5 through FL-R8 are Mr. Cunningham's responses to Data Requests NG-Staff 1-113, 114 and 115 and the additional detail requested by Mr. Cunningham in those responses. Utilizing Mr. Cunningham's approach but with the full year of data requested by Staff, results in a revised pension expense of $2,422,429 and OPEB expense of $595,620, which would require an increase of $2,798 to the current base level of expense included in the Company's original filing (as compared to Staff's recommendation of a reduction of $44,372).

6. Depreciation

Q. What is the Company's position on Staff's proposal to reduce depreciation expense by $154,097?

A. As noted above, the Company accepts the Staff's position on utilizing an adjusted end of period rate base to set rates in this case. The $154,097 reduction in depreciation expense recommended by Staff is primarily associated with the removal of depreciation resulting from the Company's updating of rate base for non-growth capital for the period through September 2010. However, $3,172 of Mr. Cunningham's depreciation adjustment arises from Staff's use of incorrect depreciation rates on Schedule JJC 5. As set forth in the Company's work papers filed in this case, the depreciation rates used by the Company are consistent with those determined in the depreciation study approved in DG 08-009, and therefore the total depreciation adjustment should be a reduction of $150,925.

Q. In summary, what is the Company's adjusted position on depreciation expense?

A. In its revised revenue requirement filing, Exhibit EN 2-2-4 included in Attachment FL-R1, the Company has updated its depreciation expense to eliminate the estimated depreciation expense on non-growth capital originally filed at $150,925 resulting in a decrease to proforma depreciation expense from $8,042,552 to $7,891,627.

III. Response to Adjustments by OCA

Q. Mr. Traum also proposed a number of adjustments to the Company's revenue requirement. What is your response to those?

A. To the extent that I have not already addressed Mr. Traum's proposed adjustments in my discussion of the issues raised by Staff, I will attempt to cover them below. The items I will address are as follows:

- Contract Center Consolidation
- Normalizing Adjustments
- Payroll and Payroll Taxes
- T&D Mains and Services Expense
- Maintenance Free Bin Activity
- Property Structure Maintenance Activity
- Health and Welfare Benefits
- Postage
- Office Supplies

A. Contract Center Consolidation

Q. Mr. Traum asserted in his testimony that the Company's operating expenses should be reduced by $163,000 for what he called the contract center consolidation. What is your response to that proposal?

A. The expense referred to by Mr. Traum as the contract center consolidation relates to expenses incurred with regard to the Company's call center. The amount that the OCA proposes to remove from operating expenses reflects a portion of the labor and burdens associated with operating the call center, rather than a one-time expense as OCA suggests. As stated in the Company's response to Data Request OCA 3-28, a copy of which is attached as Attachment FL-R9, the primary drivers of this expense increase relate to customer billing and accounting costs. Test year expenses increased from prior years because the level of customer inquiries received increased. There is no basis to believe that this expense will drop back to lower levels and, in fact, the test year level of expense ($983,787) recorded to the relevant account (Account 9030K Activity 003602) is generally consistent with the amounts booked for calendar 2009 ($1,342,649), 2008 ($756,525.50), and 2007 ($886,067.45). For the period through October 2010, the expense for this account is $1,045,888.

Q. Mr. Traum's testimony references a comment in the Staff audit report that indicates that the Company stated that the primary driver of the expense increase was consolidation of the call center. What is your response to his reliance on that

statement in recommending that the expense increase be excluded from the revenue requirement?

A. Mr. Traum's testimony relies on the summary in the Staff audit, rather than the complete response provided to Staff during the audit process, which may explain his misunderstanding. During the audit process, the Company explained to the Staff auditors that, although the call center was in fact consolidated, the Company experienced increased labor costs in response to an increase in the level of customer inquiries received in the normal course of business. The Company also noted to Staff the normal year-to-year variations in expense that have been experienced and indicated that the test year level was essentially consistent with prior experience, particularly in light of the increased customer-generated activity. The Company stressed to Staff that the test year expense level reflects the normal course of business, including the variability of customer inquiry drivers such as gas costs and weather. Based on this information, the Commission's audit staff did not identify a specific audit issue.

B. Normalizing Adjustments

Q. Mr. Traum also argued that the Commission should "normalize" a number of expenses, rather than using the test year amounts. What is the Company's position on these proposed expense adjustments?

A. The expenses that Mr. Traum asserted should be averaged over a period of years and the associated reductions he is proposing for operating expense are as follows:

Capitalized payroll and payroll taxes - $297,566

Transmission and distribution mains and services expense - $146,130

Maintenance free bin activity - $6,617

Property structure maintenance - $43,975

The Commission's ratemaking process is based on test year/historical data, and it is inappropriate and inequitable to selectively use average data from a period of years to determine the revenue requirement, other than with regard to those few expenses that are highly volatile or where there is clearly a significant one-time variation. There is nothing noteworthy about the test year expenses for the items selected by the OCA for normalization, except that the use of an average results in a somewhat lower expense. It would be easy enough to identify other accounts where the use of an averaging approach would lead to an increase from the test year. The Company experiences variability in the activities selected by the OCA that is tied to normal system operations and the impact of weather and system performance. That said, a pure averaging approach would be expected more often than not lead bias expense toward the low side (i.e., an amount below the test year amount) simply because of the upward trend of most expense categories over the long run. The OCA has not presented a compelling reason to use an amount other than the test year expense for these items. In addition, with regard to the OCA's proposed adjustment for capitalized payroll and payroll taxes, if the OCA's proposal of increasing the capitalized percentage of payroll and payroll taxes were adopted, the Commission would have to make a corresponding increase to rate base rather than simply reducing operating expense as the OCA has done.

C. Health and Welfare Benefits

Q. Mr. Traum proposed a reduction of $75,000 to the Company's health and welfare benefit expense. What is the Company's response?

A. The Company agrees that an adjustment of $37,688 is appropriate, but not $75,000 as proposed by the OCA. Mr. Cunningham, on behalf of Staff, proposed a reduction of $21,968 in his testimony. Based on Mr. Cunningham's response to Data Request NG-Staff 1-106 (see Attachment FL-R10), the Company has increased this adjustment to $37,688. Mr. Traum's larger reduction is based on an estimate of potential future reductions and is not known and measurable. In particular, the study on which Mr. Traum based his estimated amount was done by National Grid USA on a company-wide basis. In addition to being a projection of potential savings only, the study did not attempt to allocate the projected savings to individual operating subsidiaries and therefore Mr. Traum's figure is highly speculative and is not known and measurable.

D. Postage

Q. Mr. Traum also proposes a reduction in postage expense in the amount of $4,719. Does the Company oppose this change?

A. Yes. While the Company understands the OCA's assumption that postage requirements will diminish over time, the fact is that postal rates have moved steadily upward and are expected to continue to do so. Moreover, the total number of bills rendered has continued to increase at a rate that causes the total number of bills mailed to increase even as a higher proportion of customers elect to receive their bills electronically. The following table illustrates this for the test year and the most recent twelve month period for which the Company has the data.

Date Range	Total Bills Rendered	Total Bills "Mailed"	%
7/1/08 - 6/30/09	1,040,969	983,692	94.50%
5/20/09 - 5/19/10	1,055,467	984,622	93.29%

E. Office Supplies

Q. Mr. Traum also proposed a $16,248 reduction in operating expense for office supplies. What is the Company's response to that proposal?

A. This reduction relates to savings that the Company hopes to be able to achieve in the future as the result of putting its office supply requirements out to bid. The contract was entered into after the close of the test year and the projected savings at this point remain a forecast and are not known and measurable. Moreover, the potential savings are based on the potential volume of transactions, and therefore the savings cannot be determined in advance of the contract being fully implemented.

F. Collections Expense

Q. Mr. Traum proposes that the Company's $776,886 pro-forma adjustment for increased collection costs be removed from the revenue requirement. What is the Company's response to that proposal?

A. The Company disagrees with OCA's position of excluding the estimated costs related to reducing collections expense for the purpose of setting rates. The Company has already begun implementation of many of these programs, and completion of the process of rolling them out is a critical part of the Company's efforts to mitigate the impact of the current economic crisis on the Company's uncollectible accounts. As noted by Ms. McCarthy and Mr. Hirshey, the one program that the Company has decided not to implement is the replevin process, and therefore the Company agrees that the $46,000 associated with this program should removed from this case.

IV. Pension/OPEB Reconciling Mechanism

Q. What is the Company's response to Staff's opposition to a pension/OPEB reconciling mechanism?

A. The Company continues to believe that it is critical for the Commission to consider the need for such a mechanism, given the large and unpredictable nature of this expense and the fact that it is largely out of the control of the Company's management. In my direct testimony, I explained in detail why such a mechanism is needed. Mr. Cunningham argues in his testimony that the Company is wrong when it says that pension and OPEB expense is volatile, but an examination of the history and forecast of the expense levels shows otherwise. The table set forth below updates that information provided in my direct testimony:

<u>As Filed updated with FY 10 Actual:</u>

	Actual FY 2005	**Actual** FY 2006	**Actual** FY 2007	**Actual** FY 2008	**Actual** FY 2009	**Actual** **FY 2010**
Total Pension \ OPEB	$3,342,970	$3,217,638	$3,276,174	$2,371,402	$2,457,129	$3,959,753
$ Change		($125,332)	$58,536	($904,772)	$85,727	$1,502,623

I recognize that there are years where combined pension/OPEB expense has been relatively steady, but there are also years where the expense has varied by enormous amounts. Pension and OPEB expense totals about $3-4 million annually in the aggregate—a huge expense for a company whose annual earnings before taxes are on the order of $8-10 million (see Exhibit 2-2-1 in the Company's original filing). By comparison, in the last five years there was one year where that expense first dropped by $900,000 in a single year (a 28% change) and then only two years later rose by $1.5 million (a 61% change). Certainly, there have been several years where the expense remained little changed from the prior year, but one must ask how can a company effectively manage its financial needs and achieve some level of consistent earnings when it has no idea whether an expense will be on or close to budget or off by a million dollars or more?

Reconciling mechanisms for pension and OPEB expense have become quite common in the gas and electric utility business. For example, National Grid has pension and OPEB reconciliation mechanisms for most of its utilities that operate in New York, Massachusetts and Rhode Island. In addition, the results of a recent survey published by Mercer regarding regulatory treatment of retirement plan costs shows that nearly half of the respondents to the survey have some type of reconciling mechanism for pension and OPEB expenses. (See Attachment FL-R11, slide 10 of which indicates that the industry trend is towards more pension and OPEB reconciling mechanisms.)

The current system of recovering these costs is plainly broken and needs some kind of fix. The Company's proposal will protect both the Company's customers and its shareholders and will help reduce the need for frequent general rate cases. The Company believes the best approach to address the potential and significant swings in pension/

OPEB expense would be to implement a pension and OPEB tracking mechanism to prevent both the customer and the Company from being harmed or conversely enriched by significant swings in pension and OPEB expense.

Q. Can the Company provide additional detail in support of the volatility discussed?

A. Yes. As provided in Staff 1-3, a copy of which is attached as Attachment FL-R12, the discount rate and actual return on plan assets in particular can have a significant impact on pension and OPEB expense. The following table provides a historical summary of the discount rate utilized:

National Grid Discount Rate Summary

Measurement Date	Discount Rate[1]
03/31/2010	6.10%
03/31/2009	7.30%
03/31/2008	6.50%
08/24/2007	6.50%
12/31/2006	6.00%

[1] Used for both pensions and PBOPs

In addition, the following table provides a historical summary of National Grid's asset returns – Actual and Expected:

National Grid Actual Asset Returns

Measurement Period	Pension Returns	OPEB Returns
03/31/2009 - 03/31/2010	32.30%	36.80%
03/31/2008 - 03/31/2009	-27.40%	-27.40%
08/24/2007 - 03/31/2008[2]	-3.00%	-3.00%
12/31/2006 - 08/24/2007[3]	5.80%	6.90%
12/31/2005 - 12/13/2006	13.60%	12.40%

National Grid Expected Asset Returns

Measurement Period	Pension Returns	OPEB Returns
03/31/2009 - 03/31/2010	8.00%	7.70%
03/31/2008 - 03/31/2009	8.00%	7.60%
08/24/2007 - 03/31/2008[4]	4.60%	4.40%
12/31/2006 - 08/24/2007[5]	5.60%	5.30%
12/31/2005 - 12/13/2006	8.50%	8.00%

The impact of simply decreasing the discount rate and the asset returns by 100 basis points each (based on FY 2011 expense) is to increase EnergyNorth direct pension costs by $422,000. The impact on EnergyNorth direct OPEB costs is much smaller at $10,000, although the two should be seen in their totality. These amounts are EnergyNorth's direct cost increases only, and do not include the additional increase in expense that would be

[2] Represents earnings for the 7 month period (non-annualized)

[3] Represents earnings for the 8 month period (non-annualized)

[4] Represents expected earnings for the 7 month period (non-annualized)

[5] Represents expected earnings for the 8 month period (non-annualized)

allocated from its affiliated service companies due to 100 basis points decreases in the discount rate and asset return rate.

The Company's proposal for a reconciling mechanism is meant to keep all parties (shareholders and customers) protected from the volatile market conditions illustrated above. It is a fair and equitable means of addressing this significant problem.

Q. Does this conclude your testimony?

A. Yes, it does.