STATE OF NEW HAMPSHIRE

PUBLIC UTILITIES COMMISSION

DG 17-070

In the Matter of:
Northern Utilities, Inc. Request for Change in Rates

Direct Testimony

of

Stephen P. Frink
Assistant Director – Gas & Water Division

December 20, 2017

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New Hampshire Public Utilities Commission

Northern Utilities, Inc.

Request for Change in Rates

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**Testimony of
Stephen P. Frink**

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. I joined the Commission in 1990 as a member of the Audit Team and worked as a Utility Analyst and Sr. Utility Analyst before becoming the Assistant Finance Director in 1998. In 2001 Commission operations were restructured and I became the Assistant Director of the Gas & Water Division and have primary responsibility for the administration of the financial aspects of the regulation of the gas utilities.

Prior to joining the Commission I worked as a Budget/Financial Analyst for the cities of Austin and Dallas, Texas. I have a Bachelor of Arts and a Master's in Business Administration from the University of New Hampshire.

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

A. The purpose of my testimony is to address the revenue requirements and revenue deficiency proposed by Northern Utilities, Inc. and to present Staff's recommended ratemaking adjustments on the Company's revenue deficiency. My testimony also addresses the Company's proposed rate plan and recommends changes to the Residential Low Income Assistance Program (RLIAP).

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

A. Staff recommends a $1,280,870 increase in the revenue requirement, or $3,447,575 less than the $4,728,445 proposed by the Company. The following table summarizes Staff's recommended adjustments to rate base, revenues and expenses and the impact on the revenue deficiency.

Table 1: Staff Recommended Adjustments & Impacts

		Rate Base	Operating Income	Revenue Deficiency
1	Adjust Cash Working Capital for Expense Adjustments	(52,516)	0	(6,414)
2	To Annualize 2016 Revenues for Customer Growth		(95,705)	157,960
3	Remove Legal Costs Related to Notices of Probable Violations		67,740	(111,804)
4	Audit Issues Northern Agreed Upon		14,459	(23,864)
5	Eliminate Inflation Allowance		82,924	(136,865)
6	Eliminate 2018 Wage Increase	(124,256)	127,847	(226,187)
7	Eliminate Increase to 401(k) for 2018 Increase to Payroll	(5,970)	6,680	(11,755)
8	Eliminate 2018 Increase in Medical and Dental Insurance	(23,891)	22,762	(40,486)
9	Eliminate Restricted Stock Plan & Incentive Pay tied to EPS	(348,438)	349,169	(618,857)
10	Eliminate 2018 Increase to Insurance Premiums	(18,499)	13,784	(25,010)
11	Eliminate 2017 estimated increase in Property Tax		131,010	(216,231)
12	Sharing of Directors and Officers Liability Insurance	(10,199)	7,914	(14,308)
13	Modifications to Depreciation and Amortization	231,365	140,179	(203,106)
14	True-Up Payroll Taxes for Other Adjustments		14,685	(24,237)
15	Interest Synchronization		(4,134)	6,823
		(352,402)	879,314	(1,494,342)

Staff does not support the Northern Rate plan and recommends two step adjustments with the second on at the election of the Company and would trigger a rate case stay out.

The RLIAP should be modified to provide for an annual RLIAP rate adjustment and designed to produce a 25% saving from the total annual cost for an average residential heating customer as projected in the Company's annual winter COG filing in year 1 and 20% thereafter. The RLIAP rate is currently a 60% discount from the residential heating customer delivery rate and has been in effect since 2006.

Revenue Requirement

Q. What revenue increase has been requested by the Company?

A. Northern has proposed a $4,728,445 increase in annual revenue, or approximately 7.3% over the Company's total revenue requirement under present rates. The rate increase is intended to provide a 10.3% return on equity.

Q. Are temporary rates currently in effect?

A. Order 26,043 issued July 31, 2017 approved temporary rates designed to yield an increase of $1,600,000 in annual revenues, effective August 1, 2017.

Test Year

Q. What is the test year being used in this case?

A. The Company and Staff calculated the revenue requirement using a historical test year of the 12 months ending December 31, 2016.

Q. Did Northern make adjustments to the test year?

A. Yes. The Company stated it made adjustments to the test year based upon known and measurable changes to revenues and expenses, or upon changes that will become known and measurable during the course of the proceeding. The Company adjusts for changes through July 1, 2018. [1]

Q. Northern included adjustments beyond one year past the end of the test year?

A. Yes, Northern made numerous adjustments for 2018 that are beyond twelve months past the end of the test year.

Q. Is that a departure from past Commission practice?

A. Yes, Commission practice is to use a historical average test year and avoid the use of extensive adjustments to operating results beyond twelve months after the end of the test year. Staff has removed the 2018 adjustments.

Q. What was the Company's reasoning for adjusting the historical test year to include costs beyond twelve months past the end of the test year?

A. Northern argues that the rates should reflect the cost of service it will be experiencing when permanent rates are awarded to ensure sufficient revenues to continue to ensure safe, reliable and cost-effective delivery service for customers and to provide a reasonable opportunity to earn its authorized rate of return.[2]

Northern explains that it has been experiencing earnings attrition, as utility costs have risen faster than revenues and has affected the Company since 2010. Investments in non-revenue producing assets have caused its fixed costs including depreciation, property taxes and return to rise faster than revenues, and inflationary pressures on other operating and maintenance costs has further widened the gap between costs and revenues.[3]

1 Northern Direct Testimony of David L. Chong, Bates pages 20-21.
2 Northern Direct Testimony of David L. Chong, Bates page 21.
3 Northern Direct Testimony of David L. Chong, Bates page 18.

Q. Does Staff agree that such adjustments are necessary to provide Northern a reasonable opportunity to meet its service obligations and earn are reasonable return?

A. No. Northern has the ability to control costs and increase revenues through customer growth. Step adjustments provide for annual rate increases on non-revenue producing assets which address one of the two reasons cited by Northern for earnings attrition. The other reason cited is inflationary pressures on other operations and maintenance but Northern has some control over those costs and the ability to offset the inflationary pressure through increased productivity and by increasing revenues through continued customer growth.

Northern has demonstrated the ability to do just that. Since Northern's last rate increase, which was based on a historical test year with adjustments for known and measurable changes in the twelve months past the end of the test year, Northern has earned close to its approved return. Northern's authorized return on equity is 9.50% and the annual weather normalized returns for 2014, 2015 and 2016 were 9.28%, 8.60% and 8.47%, respectively.[4]

Another factor to consider is temporary and permanent rates are reconciled and therefore the effective date of the permanent rate increase is, in essence, August 1, 2017 and the Company's pro forma adjustments for changes in 2018 would not be representative of the Northern's 2017 cost to serve.

<u>Adjustments to Rate Base</u>

Q. What rate base has the Northern proposed?

A. Northern's proposed rate base is $131,491,801.[5]

Q. Is Staff proposing any adjustments to the Northern's proposed rate base?

A. Yes, Staff is recommending adjustments to the following rate base components:

- Cash Working Capital
- Capitalized Portion of payroll related to 2018 increases and the Restricted Stock Plan and EPS Component of Incentive Pay
- Capitalized Portion of Directors and Officers Liability Insurance and 2018 increase in medical and dental insurance
- Depreciation and Amortization

Q. Please explain Staff's recommended adjustment to Cash Working Capital.

A. Cash Working Capital is one of the Working Capital components of rate base. The Company's Cash Working Capital was developed through the preparation of a lead-lag study. The lead-lag is applied to each component of the cost of service to quantify the cash working capital requirement associated with that cost of service item. The cash working capital balance must be updated to reflect Staff's adjustments. Staff's adjustment is provided in Schedule 3.1.

Q. Please explain Staff's recommended adjustment to Accumulated Depreciation and Amortization.

A. Staff's adjustment to Accumulated Depreciation and Amortization recognizes the offsetting impact to rate base for Staff's adjustment to expenses for the Modifications to Depreciation

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4 Northern Schedule DLC-2, Bates page 54.
5 Northern Schedule RevReq-5, Bates page 145.

and Amortization recommended by Staff witness Al-Azad Iqbal. The adjustment is shown on Schedule 3.13.

Q. Please explain Staff's recommended adjustment for the Capitalized Portion of the Restricted Stock Plan and EPS Component of Incentive Compensation.

A. Staff's adjustment for the capitalized adjustment for the Capitalized Portion of the Restricted Stock Plan and EPS Component of Incentive Compensation removes the capitalized portion of these expense items that the Northern has allocated to its rate base. The adjustment is discussed later in my testimony and is shown on Schedule 3.9.

Q. Please explain Staff's recommended adjustment for Directors and Officers Liability Insurance.

A. Staff's adjustment for Directors and Officers Liability Insurance removes the capitalized portion of this expense that the Northern has allocated to its rate base. The adjustment is discussed later in my testimony and is shown on Schedule 3.10.

<u>Adjustments to Operating Income</u>

Q. What net operating income has Northern proposed?

A. Northern's proposed operating income is $8,048,949.[6]

Q. Is Staff proposing any adjustments to the Northern's net operating income?

A. Yes, Staff is recommending the adjustments to the following revenue and expense components:

- Revenue - Annualize Test Year Customer Sales

- Expense – Legal expense to Challenge Notices of Probably Violations
- Expense – Staff Audit Issues Northern Agreed Upon
- Expense - Eliminate Inflation Allowance for 2018
- Expense – Eliminate 2018 Wage Increase
- Expense – Eliminate Increase to 401(k) Associated with 2018 Wage Increase
- Expense – Eliminate 2018 Increase in Medical and Dental Insurance
- Expense – Eliminate Restricted Stock Plan and EPS Component of Incentive Compensation
- Expense – Eliminate 2018 Increase to Insurance Premiums
- Expense – Eliminate 2017 Estimated Increase in Property Tax
- Expense – Sharing of Directors and Officers Liability Insurance
- Expense – Modifications to Depreciation and Amortization
- True-Up Payroll Taxes for Other Adjustments
- Interest Synchronization

Q. Please explain Staff's recommended adjustment to annualize test year sales.

A. Staff recommends that operating revenue should be based on a year-end customer count in order to be consistent with the recognition of year-end plant in service in rate base. The impact on test year revenue was calculated by multiplying the difference between the test-year year-end number of customers and the average number of test-year customers by the average revenues per customer by customer class. Although there was an increase in the number of residential heating customers, some of the larger commercial and industrial customer classes

6 Northern Schedule RevReq-2, Bates page 113.

experience a decrease in customers resulting in net decrease in test year revenues based on year-end customer counts. Staff has reduced test year revenue by $157,960 to reflect year-end customer counts.[7] The adjustment is shown on Schedule 3.2.

Q. Please explain Staff's recommended adjustment to remove the outside legal expenses Northern incurred in response to Notices of Probable Violations (NOPV).

A. Test year expenses include $111,805 for outside legal ($88,084) and consulting ($20,533) services Northern incurred in response to NOPV. Northern paid a $30,000 fine for the noticed violations. Staff has removed the outside costs related to the NOPV for several reasons.

NOPV are administrative proceedings which fall under the Puc 500 rules and therefore do not require counsel, public notice, transcripts and other costs common to the proceedings to which the PUC 200 rules apply. The rules do not prohibit Northern from engaging outside council in lieu of or in addition to in-house council, but doing so resulted in excessive costs that rate payers should not be responsible for.

Northern was found to have had safety violations and paid a $30,000 fine and for which Northern is not seeking recovery. Ratepayers are not expected to pay for fines utilities incur for safety violations and they should not be required to pay for excessive costs incurred in contesting those violations.

These costs are one-time expenses. Staff does not expect Northern to employ outside council and experts in response to future NOPV. The adjustment is shown on Schedule 3.3.

Q. Please explain Staff's recommended adjustment for the audit issues Northern agreed

7 Response to Staff Technical Session DR 1-17. (Attachment SPF-2)

upon.

A. The Commission Audit Staff audited Northern books and records and found a number of items that Northern agreed should be corrected. Staff's adjustment makes those corrections and is shown on Schedule 3.4.[8]

Q. Please explain Staff's recommended adjustment to eliminate Northern's inflation allowance.

A. Northern has proposed an inflation adjustment that "increases 'residual O&M expenses' to recognize the general level of rising costs due to inflationary pressures." The Company used "the term 'residual O&M expense' to refer to such items as fuel for Unitil Energy's fleet of utility vehicles, professional fees such as actuarial, audit and legal services, office supplies, telecommunications expense, natural gas for heating, cleaning and building maintenance, snow removal and other contractor services." The Company stated that "it is not feasible to project specific adjustments for residual O&M expense that are comparable to adjustments made to other expense categories." The Company's adjustment applies a 4.26% estimated inflationary factor to "residual O&M expenses" and increases test year O&M expenses by $136,865.[9] Staff's adjustment removes the inflation adjustment as not known and measurable. The adjustment is shown on Schedule 3.5.

Q. Did Northern provide an explanation on why it is seeking escalated O&M costs beyond the end of the test period?

A. Yes. Northern argues that

8 Attachment SPF-4
9 Northern Direct Testimony of David L. Chong (Bates pages 31-32) & Schedule RevReq-3-14 (Bates p. 129)

> "All adjustments to the test year cost of service are based upon known and measurable changes to revenues and expenses, or upon changes that will become known and measurable during the course of this proceeding. As a practical matter, the Company has limited all pro forma adjustments to those that will be known and measurable through July 1, 2018, or the effective date of permanent rates."[10]

However, the Company's inflation adjustment is inconsistent with the Company's argument. An inflation adjustment beyond twelve months past the end of the test year is not known and measureable. It is based on an estimate that has been applied to O&M expenses that may not be directly impacted by inflationary pressures even if the estimated inflation factor used by the Company turns out to be close to actual inflation.

Q. Please explain why an inflation adjustment is not appropriate.

A. First, the Company used a historical test year with what it claims are "known and measureable" changes. Using an estimated inflation adjustment for "residual O&M expenses," along with the other adjustments for 2018, the Company has, in essence created a future test year. This goes against traditional "known and measureable" ratemaking practices. These estimated inflationary adjustments are not known and measureable. Second, applying a common inflation factor to all "residual O&M expenses" ignores other factors that can affect these residual costs. For example, fuel prices vary significantly by supply and demand. Legal costs are influenced by the actual legal issues that arise, not simple inflationary factors. Finally, arbitrarily applying an estimated inflation factor to a test year O&M expenses removes the important responsibility of management to control costs.

Q. Please explain Staff's recommended adjustment to eliminate the 2018 wage increase.

A. Northern has proposed a wage and salary increase for 2018, which is more than twelve

10 Northern Direct Testimony of David L. Chong, Bates pages 20-21.

months past the end of the test year. The Company has included a 3.63 percent increase for Northern & USC Non-union employees effective January 1, 2018 and a Union increase of 3.0 percent effective June 3, 2018.[11] Staff's adjustment removes this increase as it is too far beyond the end of the test year and is not known and measureable. The Company is attempting to create an estimated future test year and its request should be denied. The adjustment is shown on Schedule 3.6.

Q. Please explain Staff's recommended adjustment to eliminate the increase in the 401(k) associated with the 2018 wage increase.

A. The Company's 2018 proposal to increase 2018 wages results in an increase in its 401(k) program. Consistent with Staff's adjustment to eliminate the 2018 wage increase, the increase to the 401(k) should also be removed. The adjustment is shown on Schedule 3.7.

Q. Please explain Staff's recommended adjustment to eliminate the 2018 increase in medical and dental insurance.

A. Staff's adjustment removes the Company's 2018 increase in medical and dental insurance as it is too far beyond the end of the test year and is not known and measureable. Again, the Company is attempting to create an estimated future test year and its request should be denied. The adjustment is shown on Schedule 3.8.

Q. Please explain Staff's recommended adjustment to eliminate Restricted Stock Plan and EPS Component of Incentive Compensation.

A. The Company has a Restricted Stock Plan that is awarded based exclusively on accomplishing shareholder focused goals. The Company's Incentive Compensation Plan also has a

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11 Northern Schedule RevReq-3-7, Bates pages 121-122.

significant focus on shareholder related goals. Staff's adjustment removes the Restricted Stock Plan and the portion of Incentive Compensation that is related to shareholder goals. The adjustment is shown on Schedule 3.9.

Q. Did Staff address the Restricted Stock Plan and EPS Component of the Incentive Compensation in DG 16-384?

A. Yes, Staff filed testimony in DG 16-384 recommending the expense related to the Restricted Stock Plan and EPS component of the Incentive Compensation should not be recovered from Unitil Energy Systems, Inc. (UES), Northern's sister company, as the focus is on shareholder related goals. The Restricted Stock Plan and EPS Component of the Incentive Compensation are the same for both UES and Northern and have not changed since the UES filing. The Commission did not rule on this issue in DE 16-384 as a comprehensive settlement agreement was reached and approved by the Commission.

Q. Please explain Staff's adjustments regarding Restricted Stock.

A. The Company's Restricted Stock Plan grants Share and Restricted Stock Units with the objectives of the plan "to optimize the profitability and growth of the Company through incentives that are consistent with the Company's goals and which <u>link the personal interests of Participants to those of the Company's shareholders</u>… [emphasis added]."[12] The Plan document states that the performance measures to be used for awards "shall be chosen from among earnings per share, economic value added, market share (actual or targeted growth), net income (before or after taxes), operating income, return on assets (actual or targeted growth), return on capital (actual or targeted growth), return on investment (actual or targeted growth), revenue (actual or targeted growth), share price, stock price growth, total shareholder return, or other performance measures as are duly approved by the Committee and the Company's shareholders."[13] All of these goals are focused on benefit for the Company's shareholders. Since award is based on accomplishing goals associated with the interest of the Company's shareholder, Staff's adjustment transfers the responsibility for funding the plan to the shareholders where it belongs.

Q. How much has the Company expensed related to the Restricted Stock Plan in the test year?

A. During the test year, $2.15 million was expensed related to the Restricted Stock Plan. Through the USC billing process, $279,009 was allocated to Northern as O&M expenses in the test year and $122,616 was allocated to Northern capital charges.[14] Staff's adjustment appropriately removes the amount allocated to Northern for both expenses and rate base for the test year.

Q. Is Staff's recommended adjustment to Incentive Compensation also based on transferring the responsibility of funding to the shareholders that receive the benefit of the goals achieved?

A. Yes. Staff has applied the same logic to the Incentive Compensation program. However, only a portion of the Incentive Compensation should be transferred to the shareholders, since some of the goals are focused on ratepayers.

Q. Please elaborate.

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12 NU response to Staff Tech 2-24, Attachment 3 page 2 of 14 (Attachment SPF-4)
13 NU response to Staff Tech 2-24, Attachment 3 page 10 of 14 (Attachment SPF-4)
14 NU response to Staff 1-14, Attachment 1 (Attachment SPF-5)

A. The Company has a management Incentive Compensation Plan. (Union employees are not eligible for incentive compensation). The amended and restated Plan document states that the participation is for "employees of Unitil Corporation and its subsidiaries" (of which Northern is a participant).[15] Prior to the beginning of each Performance Period, objectives are established that must be achieved prior to award. The objectives are given a ranking "based on the relative impact of each Performance Objective on the Corporation's performance."[16] The goals are the same for both senior management and non-union employees. Union employees are not eligible for participation. The following table provides the Performance Objective and relative weight for 2014 through 2016 and the amount of Incentive Compensation that was charged to Northern. [17]

Table 3: Incentive Compensation Perfromance Measures,
Weighting and Amount Charged to Northern

	Weight of Measures		
Measure	2014	2015	2016
Earnings per Share (EPS)	40%	40%	40%
Gas Safety-Response to Odor Calls	10%	10%	10%
Reliability-SAIDI Minutes	10%	10%	10%
Customer Satisfaction	10%	10%	10%
O&M Cost per Customer	30%	30%	30%
	100%	100%	100%
Total Incentive Compensation	3,754,132	3,737,123	3,959,696
Allocation Factor - Northern	17.75%	18.51%	18.68%
Total Incentive Compensaton to Northern	666,358	691,741	739,671

Q. How much of the Incentive Compensation costs does Staff believe should be funded by shareholders?

A. Forty percent. For the last three years (2014-2016), Earnings per Share (EPS) has been

15 NU response to Staff Tech 2-24, Attachment 2 page 1 of 5 (Attachment SPF-4)
16 NU response to Staff Tech 2-24, Attachment 1 page 2 of 5 (Attachment SPF-4)

weighted 40%. EPS is a shareholder-related goal. Therefore, the Company's shareholders should fund that portion of the Incentive Compensation that is focused on their behalf. The result is a sharing between the shareholders and ratepayers who each receive some benefit from the accomplishment of the goals.

Q. Please explain why Staff believes that the shareholders should fund the Restricted Stock Plan and the EPS portion of Incentive Compensation and not the ratepayers.

A. The award of Restricted Stock is based on goals like EPS, which are driven by increases to net income or profitability. Forty percent of the weighted goals for Incentive Compensation payout are awarded based on achieving a specified EPS goal. EPS or profitability goals are aligned with the interests of the Company's shareholders. There is a significant monetary incentive for management to focus on these shareholder-focused goals in order to obtain payouts through the Restricted Stock Plan and Incentive Compensation. To increase profitability during a period of slow revenue growth, a company must focus on reducing expenses (or increase its authorized return on its assets). While reducing expenses can and should benefit ratepayers, taken to an extreme, it can harm customers.

Q. Please explain why focusing on shareholder-related goals can hurt ratepayers.

A. Reducing expenses drives up net income or profitability that should benefit ratepayers. However, if there is an over focus on profitability in order to receive Restricted Stock or Incentive Compensation payouts, the shareholders are receiving benefit at the expense of ratepayers. For example, expenses can be reduced by deferring maintenance (resulting in increased outages). Further, expenses can be reduced by failing to adequately staff Customer

17 NU response to Staff Tech 2-24, Attachment 4 pages 1-3 & Attachement 5 (Attachment SPF-4)

Services. As an example, customers could have an outage and be without power and it is difficult to access customer service to report the outage. Customer services will also have long weight times for other inquiries, or complaints if it is understaffed to reduce costs and drive up profitability. By reducing expenses, the Company's management has met its EPS goal (40%) and O&M Cost per Customer goal (30%). Increased outages from deferred maintenance and lack of customer access to report the outages will result in the Company failing to achieve its Reliability goal (10%) or customer satisfaction goal (10%), but management has achieved 70% of its weighted goals at the expense of the customer.

Having goals to incent performance is a good management practices, however, it is important that incentive payments are based on performance goals that derive the desired behaviors. The Company has made the decision to put shareholders' goals above those of the ratepayers. Therefore, shareholders should fund the awards that accrue to management for achieving the goals that benefit them. Ensuring that the competing interests are balanced is also important. This balance has been achieved by requiring the sharing of incentive compensation between ratepayers and shareholders. Therefore, Staff is recommending the portion of the Incentive Compensation that more closely benefits shareholders be funded by shareholders.

Q. Is there a related adjustment to rate base?

A. Yes, an adjustment was made to remove the Restricted Stock Plan and EPS Component of Incentive Compensation that the Company allocated to capital.

Q. Please explain Staff's recommended adjustment to eliminate the 2018 increase in Insurance Premiums.

A. The Company included estimates for 2018 increases to various property and liability policy premiums. These costs represent costs that are not known and measureable and will occur beyond one year past the end of the test year. Staff's adjustment replaces these 2018 unknown and unmeasured estimates with the 2017 premium costs to limit the increase to within one year past the end of the test period. The adjustment is shown on Schedule 3.10.

Q. Please explain Staff's recommended adjustment to modify Property taxes.

A. Northern Schedule DLC-4, Bates page 136, shows the municipal and state property taxes for each jurisdiction. The schedule included the tax rate and assessed value of the property for the test period resulting in a total for annualized property taxes of $3,962,803. The Company's proforma adjustment to property taxes is an increase of $678,611 for an expected increase 2017 property taxes base on the average annual increase in property taxes between 2014 through 2016. Staff's accepts the Company's annualized property tax expense as it reflects a measurable increase in 2016 property tax rates but removes the adjustment for an anticipated increase in 2017 property tax rates as it that is not known and measurable. The adjustment is shown on Schedule 3-11.

Q. Please explain Staff's recommended adjustment to Sharing of Directors and Officers (D&O) Liability Insurance.

A. Staff's adjustment removes one-half of the D&O Liability Insurance expense. The removal of one-half of this expense reflects a sharing of this insurance between shareholders and ratepayers. The adjustment is shown on Schedule 3-12.

Q. Why should the cost of D&O Liability Insurance Expense be shared between shareholders and ratepayers?

A. D&O Liability Insurance protects the officers and directors from the costs of a lawsuit. Shareholders benefit from payouts under the policy that would reduce the cost not recoverable from ratepayers. On the other hand, ratepayers benefit because having the insurance improves the ability of the Company to attract and retain qualified directors and officers and enables the directors and officers to make decisions without fear of personal liability. As a result, it is reasonable for shareholders to bear some of the cost of D&O Liability Insurance.

Q. Is there a related adjustment to rate base?

A. Yes, an adjustment was made to remove one half of the D&O Liability Insurance that the Company allocated to capital.

Q. Please explain Staff's recommended adjustment: Modifications to Depreciation and Amortization.

A. Staff's Modification to Depreciation and Amortization adjustment is supported by Staff witness Al Azad Iqbal. The results of that adjustment are shown on Schedule 3.13.

Q. Please explain Staff's recommended adjustment: True-Up Payroll Taxes for Other Adjustments.

A. Payroll taxes reflects the effective tax rate for the Company's Social Security and Medicare taxes that correspondingly decrease as a result of Staff's adjustments to employee compensation. The adjustment is shown on Schedule 3.14.

Q. Please explain Staff's recommended adjustment: Interest Synchronization.

A. The interest synchronization adjustment synchronizes the rate base and cost of capital with the tax calculation using Staff's recommended weighted cost of debt. The adjustment is shown on Schedule 3.15.

<u>Rate Plan</u>

Q. Please summarize the Company's Rate Plan proposal.

A. The rate plan is similar to the step adjustment approved for Northern in its last rate filing (Order 25,653 issued April 21, 2014 in Docket DG 13-086) and has the following components:

- Three annual step adjustments (effective July 1, 2018, 2019, 2020)
- Annual revenue increases of approximately $2 million (3.0%-3.5%)
- Eligible facilities include main replacements/extensions, farm tap replacements, excess flow valve installations and Rochester reinforcement projects
- A cap on capital spending eligible for recovery through the step increase
- Recovery of cost increases related to inflation above 4%
- A three year stay out provision (through the end of 2020)
- Earnings sharing if ROE is under 7% or greater than 11%

Q. Why has Northern proposed a rate plan?

A. Northern claims that without annual revenue step increases the Company will significantly under-earn when permanent rates go into effect due to earnings attrition, related in large part to investments in non-revenue producing assets necessary to meet its utility obligations.

Q. Does Staff agree that Northern will significantly under-earn without annual step

increases?

A. No. As noted earlier when discussing earnings attrition, utilities can limit earnings attrition to some degree through cost control and customer growth. Staff appreciates that there is a certain level of spending beyond the Company's control and that some capital spending can be considered non-revenue producing (although replacing mains and service can be expected to reduce O&M costs and lower capital costs and increase revenue when adding customers during replacement) but does not necessarily lead to significant under-earning.

It is also worth noting that while a utility may be under-earing its approved return, changes in its capital structure and borrowing costs, and changes in the capital market, could mean a utility that is under-earnings its approved ROR may be over-earning relative to market expectations. Northern may be an example of that. Staff's cost of capital witness, Dr. Woolridge, recommends an ROE of 8.55% and calculated an overall rate of return of 7.40%, which reflects current market conditions and Northern's refinancing of long-term debt at a more favorable rate, both of which are well below the ROE and ROR approved in Northern's last general rate. Therefore while Northern may have been slightly under-earning its last approved return, it may have been over-earning relative to market expectations.

Q. Do you believe Northern will under-earn absent a step increase/rate plan?

A. Yes. It will be difficult for Northern to achieve its allowed rate of return without a step increase, therefore Staff supports two step increases.

Q. Does Staff support the terms and conditions in the Company's proposed rate plan?

A. For the most part Staff agrees with the Company proposal on how to calculate the revenue deficiency for costs associate with the eligible facilities but does not agree with what Northern has proposed for eligible facilities or the other conditions and provisions in the proposed rate plan.

Q. What changes do you recommend regarding the revenue requirement calculation?

A. The cost of removal should not be included in the revenue requirement and actual depreciation rates for each of the eligible facilities should be used rather than a composite rate.

Q. Why shouldn't the cost of removal be recovered through the step adjustments?

A. Those costs are typically reflected in depreciation rates and recovered through the depreciation expense. Allowing recovery of the cost of removal through the step adjustment would result in a double recovery of the expense.

Q. Why shouldn't a composite depreciation rate be used to calculate the revenue requirement for the step adjustments?

A. Using a composite rate would not accurately reflect the depreciation expense related to the eligible facilities and would probably over-stated that expense. The eligible facilities are predominately mains which have a long service life, whereas the composite rate includes such items as IT equipment and software, vehicles, furniture and other assets with much shorter average service lives.

Q. What are the eligible facilities to be recovered under the proposed rate plan?

A. Northern's eligible facilities include the following:

- Replacement of cast iron and bare steel mains and services and associated facilities
- Main extensions costing more than $30,000 that are required to serve customers under the Company's main extension policy

- Replacement of facilities caused by forced relocations due to city/state/municipal projects
- Farm tap regulator replacements
- Excess flow valve installations
- Reinforcement of the Rochester distribution system

Q. What is Staff's recommendation for eligible facilities?

A. Staff recommends that eligible facilities should be as follows:

- Replacement of cast iron and bare steel mains and services
- Main extensions costing more than $50,000 that are required to serve customers under the Company's main extension policy
- Replacement of facilities caused by forced relocations due to city/state/municipal projects
- Reinforcement of the Rochester distribution system

Q. Why exclude other facilities associated with replacing cast iron and bare steel mains?

A. It is unclear what other facilities would be included and whether or not those facilities would be replaced absent the main replacement program. For example, the Company may replace meters when replacing bare steel services and if those meters were due for retirement and would have been replaced in the normal course of business, that cost should not be eligible for accelerated recovery.

Q. Why exclude new main extensions costing less than $50,000?

A. For two reasons, to simplify the review process and to recognize that these projects will generate additional revenue.

Staff will be auditing and reviewing the proposed step increases and filing a recommendation with the Commission on the proposed step increases. Setting a $50,000 minimum cost will reduce the number of projects to be reviewed and offset the expected revenue increase related to the main extensions, thus making the inclusion of main extension projects somewhat revenue neutral. It would also help offset the increased revenue that may be realized through the Rochester reinforcement project.

Q. Why exclude farm tap regulator replacements?

A. The Commission Safety Division is investigating whether the farm taps were incorrectly installed and whether or not to issue NOPV. If the farm taps are being replaced due to improper installation the argument can be made those costs are being incurred as result of mismanagement and should not be recovered from ratepayers. Staff is also concerned with the estimated cost to replace farm taps, as the $40,000 cost may well exceed the expected revenue over the life of the service to serve a particular customer. Furthermore, unless a farm tap has failed or is expected to fail in the near future, there is no requirement that the farm taps be replaced over the next three to four years.

Staff recommends Northern work with the Safety Division in assessing the safety risks related to the farm taps and devise a plan to address the risk by the most economical means.

Q. Why exclude excess flow valve installation?

A. At this point the number and cost of excess flow valves expected to be installed is far less than the company was estimating at the time it made its rate filing. Northern estimated it would need to replace 850 over five years at a cost of 2.5 million (annual cost of $500,000). The annual cost is likely to under $100,000 and could be well below that amount. The cost of the excess flow valve installations should not have a material impact on the Company's earnings and should not be eligible for early recovery through a step adjustment.

Q. Why should the Rochester reinforcement be included as an eligible facility?

A. It is a large project that is needed to address supply reliability concerns in the Rochester area and, although it will allow for additional customer growth in that area and additional revenues, the overall impact on Company earning in the short term will be negative and could be substantially so.

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

A. The Commission should approve a modified rate plan that provides for two step adjustments, with the second step adjustment to be at the election of the Company but if taken would trigger a stay out provision prohibiting Northern from petitioning the Commission for a distribution rate increase before 2020.

Q. Does Staff recommend any other modifications to the proposed rate plan?

A. Yes. Since Staff is proposing an immediate step adjustment and no stay out unless the Company elects to file for a second step adjustment, and eligible facilities are more limited, there is no need for an inflation adjustment, earnings sharing or an exogenous event provision as proposed by the Company. The proposed investment cap should be retained but modified, with the cumulative increase in the revenue requirement capped at $4.5 million.

<u>Residential Low Income Assistance Program</u>

Q. Please provide a history of the RLIAP.

A. On May 12, 2005, the Commission issued an Order of Notice in DG 05-076 to investigate whether a low income customer assistance program for natural gas customers should be established.

Order 24,508 issued September 1, 2005 approved a RLIAP Pilot Program (Pilot Program) for the two New Hampshire natural gas utilities. The Pilot Program established a low income rate to be a 50% discount from the utility's residential heating base rates for delivery service (base rates include customer and delivery charges). Qualifying customers were expected to see a savings of approximately 15% in their annual natural gas bills, with the cost of the program (primarily low income customer discounts) to be recovered from all customers through the Local Distribution Adjustment Clause (LDAC). One of the parameters of the proposed Pilot Program was that the cost be limited to no more than one percent of the utilities' annual gross revenue.

Order 24,669 issued September 22, 2006 (Docket DG 06-120) approved the continuation the RLIAP with one modification, that the 50% discount be increased to 60%. The change was expected to increase Northern RLIAP customer savings from 14.7% to 17.6% of a customer's total bill and increase the cost of the program as a percentage of gross revenues from 0.26% to 0.31%. The Commission Analysis states (page 5):

> "Based on the sensitivity analyses submitted to the Commission, it appears that the proposed increase in the discount rate during the next program year may be accomplished within the financial cost parameters of the RLIAP. Accordingly, we conclude that it is appropriate to approve the proposed increase. However, we expect the parties and Staff to inform the Commission immediately if it should turn out that the assumptions underlying the sensitivity analyses are incorrect and the financial cost parameters of the RLIAP are jeopardized."

On October 26, 2017 Northern filed its RLIAP Quarterly Report for the 2016-2017 RLIAP program year (November 1, 2016 through October 30, 2017). The 4rd Quarter Report for the 2016-2017 RLIAP program year shows customer savings of 35% of total bills and program costs as 0.59% of gross revenue.[18]

Q. Why are the results of the program so different from what was originally anticipated?

A. Because base rates have increased and supply rates have decreased. The low income rate is a fixed percentage discount on the residential heating base rate only and the total bill consists of both delivery and supply charges so the increase in base rates and decrease in COG rates means greater savings for low income customers. Low supply costs also results in lower gross revenue for the utility, so the cost of the RLIAP represents a higher percentage of gross revenue when supply costs decline.

The disparity in how the base and supply costs have changed from the inception of the RLIAP to the present is significant. The typical residential heating customer bill impact in Northern's 2005-2006 winter COG filing shows base rate charges represented 27% of the total annual bill ($546 divided by $2,042) and the 2017-2018 winter COG filing shows base rate charges represent 54% of the total annual bill ($657 divided by $1,212).

Q. How should the RLIAP be changed to bring it back in line with the original intent?

A. The RLIAP rate should be set annually to produce 25% savings for qualifying customers based on the average residential heating customer's total projected gas costs for the upcoming 12 months in the first year following implementation and 20% savings thereafter. As is currently done, the proposed RLIAP rate should be included in Northern's winter COG filing and the approved rate would be effective for November 1 through October 30, with savings to be calculated on the projected total bill for an average residential heating customer for the 12 months commencing November 1 of that year. The filing should include the most recent

18 Attachment SPF-6.

RLIAP quarterly report for the current year and an RLIAP report with projected participation and costs for the upcoming year.

Q. Will qualifying low income customers be harmed by the proposed change?

A. In the short run, yes, which is why the proposal is to lower the discount in two phases. While the immediate impact will be fewer saving for those customers, in the long run they may see more savings if supply charges increase at a faster rate than base rate charges or if there is a spike in gas costs. Unlike the current RLIAP, which is a set discount rate of 60% of residential heating delivery rates, the proposed program change will increase the discount rate when supply costs/rates go up as part of the annual RLIAP rate adjustment.

Q. What would the 2016-2017 program savings have been under the modified program?

A. The average low income customer annual bill for November 2016 through October 2017 was $783, compared to an annual bill of $1,200 for an average non-low income residential heating customer, a savings of $417. With a 25% discount an average low income customer annual bill would have been $900, a savings of $300. With a 20% discount an average low income customer annual bill would have been $960, a savings of $240.

Q. How do the expected low income customers savings under the proposed RLIAP program compare to when the Commission approved the 60% discounted rate?

A. In 2006 low income customers were expected to save 18% or $360 on annual gas bills. Based on projected gas costs for November 2017 through October 2018, low income customers would save $300 with a 25% discount and $240 with a 20% discount. So while the percentage savings would be greater, the dollar savings are less as current bills are much lower than they were in 2005-2006.

Q. Do lower annual gas bills factor into Staff's proposed changes to the RLIAP?

A. No but it does mean the financial burden on low income customers and all firm sales customers are far less than when the RLIAP was established.

Q. Will the proposed change ensure that RLIAP costs will not exceed one percent of Northern's gross revenue?

A. No, but it should result in RLIAP costs better tracking gross revenues, as the annual RLIAP rate will reflect the current delivery and supply rates from which annual utility revenues are derived. The number of RLIAP participants will impact the cost of the program, but the number of participants has been fairly consistent over the life of the program, with an approximate annual average monthly participation of 1,000, ranging from approximately 800 to 1,200 in any given year.

Q. Will the Commission be notified if RLIAP costs exceed one percent of gross revenue?

A. Yes, RLIAP reports will be included in the COG filing and show program costs as a percentage of gross revenues for both the current and upcoming year.

Q. Will the proposed changes to the RLIAP be applicable to Liberty Utilities?

A. Staff has proposed the same changes to the RLIAP in the Liberty Utilities rate filing, DG 17-048.

Summary & Conclusion

A. Staff recommendations are:

- the Commission approve a $1,280,870 increase Northern's annual revenue requirement

- the Commission approve two step adjustments, with the second step adjusted to be at Northern's election and conditioned on a stay-out provision
- the Commission should modify the RLIAP to provide for an annual discounted rate on total gas costs.

Q. Does that conclude your testimony?

A. Yes.