

DE 04-231

UNITIL ENERGY SYSTEMS, INC.

Petition For An Accounting Order

Order Denying Petition For An Accounting Order

ORDER NO. 24,449

April 7, 2005

APPEARANCES: LeBoeuf, Lamb, Greene & MacRae by Scott J. Mueller, Esq. for Unitil Energy Systems, Inc.; Robert A. Bersak, Esq. for Public Service Company of New Hampshire; F. Anne Ross, Esq., of the Office of Consumer Advocate, for the Residential Ratepayers of New Hampshire; and Edward N. Damon, Esq. for Staff of the New Hampshire Public Utilities Commission.

I. PROCEDURAL HISTORY

On December 10, 2004, Unitil Energy Systems, Inc. (Unitil) filed with the New Hampshire Public Utilities Commission (Commission) a petition for an accounting order seeking authority to defer, and record as a regulatory asset, certain pension costs above those included in its current base rates, together with the pre-filed testimony of Unitil Controller Laurence M. Brock. On December 20, 2004, Unitil filed a revised page for Mr. Brock's pre-filed testimony. On December 22, 2004, the Office of Consumer Advocate (OCA) filed with the Commission its notice of intent to participate in this docket on behalf of residential ratepayers of New Hampshire, consistent with NH RSA 363:28. On December 29, 2004, the Commission issued an Order of Notice establishing a Pre-Hearing Conference to be held on January 12, 2005. On January 7, 2005, Public Service Company of New Hampshire (PSNH) filed a petition to intervene on a limited basis in this docket.

On January 12, 2005, the Commission held a pre-hearing conference in accordance with the Order of Notice, followed by a technical session to discuss, among other

things, an appropriate procedural schedule. On January 14, 2005, Staff of the Commission (Staff) submitted to the Commission the parties' recommendations regarding a procedural schedule. On January 18, 2005, the Commission issued a secretarial letter approving PSNH's petition to intervene and the procedural schedule recommended by the parties.

In accordance with the procedural schedule, Staff filed the testimony of Steven E. Mullen, Utility Analyst, with the Commission on January 31, 2005. On February 8, 2005, Unitil filed with the Commission copies of its rebuttal exhibits in accordance the procedural schedule. On February 9, 2005, the Commission issued a secretarial letter notifying the parties that the February 10, 2005 hearing was being postponed until February 24.

A hearing was held before the Commission on February 24, 2005; PSNH did not attend the hearing. On March 10, 2005, Unitil filed with the Commission responses to two record requests made at hearing. Post-hearing briefs were filed on March 10 and 11, 2005 by Unitil, OCA and Staff.

II. POSITIONS OF THE PARTIES AND STAFF

A. Unitil

In its initial petition, Unitil sought authorization to defer and record as a regulatory asset certain pension costs above the level included in its existing rates. Unitil states that it is not seeking authorization at this time to change its rates. Unitil maintains that its request was in response to volatility in pension expenses due to extraordinary circumstances beyond Unitil's control, specifically, a significant decline in the equity markets and decreases in interest rates. Unitil indicates that because of a dramatic increase in pension expenses, its request is an interim measure seeking to defer pension costs in 2004 and after, until such time as

the Commission issues an order in Unitil's next base rate case, to be filed no later than October 2007.

At hearing, Unitil agreed that if its deferral request is approved, it would not seek recovery of the regulatory asset in a future base rate case. Instead, Unitil states that it would offset those deferred amounts against future pension income. Unitil avers that the purpose of this agreement is to assure the Commission that granting the deferral would not result in a rate increase for customers and to address concerns that Unitil's proposal could be construed as retroactive or single-issue ratemaking. Unitil further refined its proposal in a brief filed on March 10, 2005.

Unitil argues that it is just and reasonable, and in the public interest, for the Commission to grant Unitil's request. It asserts that denying its request for relief would unnecessarily accelerate a rate case for customers and divert resources from operating activities to rate case activities; harm its financial condition and negatively impact credit quality; and penalize customers by increasing the cost of capital and passing along large rate case expenditures. Unitil states that granting its request will benefit customers and provide an incentive for Unitil to continue to fully fund its pension plan while allowing it to better manage its financial condition. Unitil states that if its request is denied, the action will precipitate the need for immediate preparation of a base rate filing to increase customer rates.

B. OCA

The OCA opposes Unitil's petition for deferral. The OCA believes that if Unitil feels it is necessary, it can petition the Commission for a rate increase, at which time the Commission could examine offsetting savings and other changes in its financial situation that may impact the losses Unitil claims to have suffered, and ensure that Unitil is not over-earning.

In OCA's view, this is a request for single-issue ratemaking which OCA believes is not sound regulatory policy in the general course. The OCA is concerned that Unitil has declined to file for a rate case, even though it claims it is under-earning. The OCA believes that the requested accounting treatment would allow Unitil to state its income as higher for purposes of Securities and Exchange Commission reporting and may result in increased year-end bonuses for certain Unitil employees.

The OCA believes that Unitil's request for deferral arose from discretionary, not mandatory, expenditures to increase pension reserves. The OCA states that because the request was not made in the context of a full rate case, it is a request for retroactive or single-issue ratemaking, and such requests have historically been rejected. The OCA disagrees with the concept of retroactive or single-issue ratemaking because there is no allowance for consideration of increased revenues or other offsetting items. The OCA states that although the Commission has allowed single-issue ratemaking regarding changes in tax laws, there is no such change in this case. The OCA maintains that Unitil has the right to file for a rate case at any time and, in any event, is required to file no later than October 2007.

The OCA is also concerned that granting Unitil's petition for deferral would "open the flood gates" for other requests for deferrals or true-ups for virtually any traditional base ratemaking expense. The OCA states that allowing single-issue or retroactive ratemaking in this case would invite more deferral requests from virtually every regulated industry.

C. Staff

Staff, too, believes this issue is more appropriately addressed in an overall rate case, where all the items of a utility's cost of service can be examined simultaneously, rather than as a single issue. Staff believes that approval of Unitil's petition will not generate

additional cash for Unutil immediately. Staff states that the immediate outcome would be that Unutil would increase its earnings without a full examination and accounting of its overall cost of service. Staff believes granting Unutil's petition would allow it to report higher earnings for 2004 and future years by removing an ordinary operating expense (with its inherent risk) from its income statement and capitalizing it as a regulatory asset on its balance sheet, which would cause its earnings to appear higher than they actually are. Staff believes that Unutil's primary reason for requesting the deferral is to enable it to report higher earnings and thereby possibly avoid sending "negative signals" – for which Staff claims the Company produced no evidence – to its financing sources. Staff also testified that the appearance of higher earnings could also affect the level of bonuses awarded to some employees.

Staff stated that under traditional ratemaking practices, pension expense is one of the numerous items of expense comprising a utility's cost of service that is reflected in its revenue requirement for base rates. Staff believes that granting the Company's petition would create a precedent that would allow utilities the opportunity to defer increases in normal operating expense line items between rate cases for future recovery solely for the purpose of managing its earnings. According to Staff, such a precedent could go well beyond pension costs to include virtually any items included in a utility's overall cost of service. Staff avers that the deferral of single-issue, ordinary operating expense line item increases between rate cases would create a problematic precedent for similar requests by other utilities. For example, one electric utility stated at the Pre-Hearing Conference that the creation and deferral of regulatory assets provide a tool that enables companies to deal with short-term rate issues; in addition, Staff stated that it was aware that similar requests for deferrals had previously been submitted to the Commission's Gas and Water Division. According to Staff, this type of ratemaking for single

issue ordinary expense line items between rate cases has historically been frowned upon by the Commission.

Staff also contends that Unitil's argument that its circumstances are unique is inconsistent with page 6 of the pre-filed testimony of its own witness, which states, "Unitil Energy, *like other utilities*, has experienced higher Pension costs in recent years due to the extreme decline in the stock market since the test year and the sharp fall in interest rates" (emphasis added). Staff is not persuaded that the circumstances are extraordinary, unique or outside of Unitil's control. Staff does not dispute the fact of economic fluctuations in the market; however, Staff contends that Unitil retained a substantial amount of control regarding the assumptions used and decisions made to determine the level of pension expense to be recognized and the amount of cash contributions to be made. Finally, Staff maintains that because Unitil is required to file a base rate case on or before October 2007 in any event, Commission approval of this request would at most only delay for a short period the time, rather than avoid, the necessity of filing a rate case and the incurrence of rate case expenses.

III. COMMISSION ANALYSIS

Unitil's petition requests that the Commission authorize it to defer, and record as a regulatory asset, certain pension costs above those included in its current base rates, beginning with its 2004 level of expense. This accounting treatment would remain in place until a final Commission order is issued in Unitil's next base rate case, which is required to be filed no later than October 25, 2007, pursuant to the Phase II Settlement Agreement approved in DE 01-247.¹ Unitil proposes to defer the amount of pension expense, net of amounts chargeable to capital,

¹ The Commission approved the Phase II Settlement Agreement in *Concord Electric Company*, 87 NH PUC 694 (October 25, 2002) (Order No. 24,072).

that is greater than zero but does not exceed, in any annual period, the amount of cash contributed to the pension plan trust accounts.

In making this request, Unitil is seeking the Commission's permission to deviate from normal accounting procedures. The Commission has permitted deviations from normal accounting procedures only in limited cases. *See e.g., Unitil Energy Systems, Inc.*, Order No. 24,269 (January 30, 2004) (Commission granted Unitil's petition for deferral of post retirement benefits other than pension so that Unitil would be treated similarly to other utilities after the enactment, in the early 1990s, of SFAS 106, which mandated new accounting treatment of certain benefit expenses). Unitil has not demonstrated a basis to conclude that extraordinary circumstances exist here that would justify a deviation from normal accounting procedures. We will therefore deny the petition.

Pension expense is an ordinary category of expense included in the revenue requirement for a utility under traditional cost of service ratemaking principles. It is determined pursuant to SFAS 87, by means of an actuarial calculation that depends on a number of assumptions, including the expected return on invested assets and long term discount rates.² In general, all else being equal, increases in the expected return on invested assets and the discount rate result in decreases in the amount of pension expense while decreases in the expected return on invested assets and the discount rate have an opposite effect.³ The expected returns on invested assets and long term discount rates have been affected by recent declines in the stock market and interest rates. As a result, while Unitil was experiencing net pension *income* at the time its revenue requirement was established in the Phase II Settlement Agreement in

² The amount of cash that may be contributed to the pension plan is a separate matter, determined in part pursuant to the Employee Retirement Income Security Act administered by the Internal Revenue Service.

³ See Hearing Transcript at 65, 68.

DE 01-247, based on a 2001 test year with, as adjusted for, known and measurable changes in 2002, it began to record net pension *expense* in 2003 and 2004.

We find that any shortfall in amounts being recovered in rates which is attributable to market fluctuations is an expected aspect of any investment scenario. Unitil itself concedes that it is not alone in experiencing higher pension costs in recent years -- other utilities have also experienced higher pension costs and the reasons are said to be the same as those for the increase in pension expense. Brock testimony, p. 6.

The fact is that investment valuations and interest rates are continually changing. In addition, as Staff pointed out in its Post-Hearing Brief, the trend in the deterioration of Unitil's pension income began before the Phase II Settlement Agreement in DE 01-247 was filed with the Commission in August 2002. That deterioration was apparent to all the parties and was recognized in the adjustments that became part of the Phase II Settlement Agreement. The deterioration was not entirely unforeseeable, nor did it only occur after the Phase II Settlement Agreement was filed. Since then, the stock market has improved and interest rates have increased as well. It is possible, though by no means certain, that Unitil's level of pension expense may improve in the future as a result.

In terms of the size of the impact of increased pension expense, Unitil points to large cumulative increases in the amount of pension expense and cash funding of the pension plan and the significant proportion that the amount of 2004 pension expense and cash funding bears to non-energy related operational expense. Unitil further states that if it is not able to create a regulatory asset as requested, it would have "lower than expected" earnings that would send a "negative signal" to its financing sources and that its "continued" absorption of increased pension costs and funding requirements into 2004 "and beyond" "could have" a material

detrimental impact on Unitil's financial position and credit quality. To bolster its argument, Unitil presented some evidence that, based on its calculations, it was under-earning at the end of 2004. However, there was contrary evidence filed by Staff on this issue. It is not clear if Unitil was in fact under-earning and, if so, to what extent. A full examination of its income and expenses will be undertaken when Unitil files a rate case. However, if Unitil believes its under-earnings are significant, it has the discretion to file before October 2007. We find that the harm to Unitil if its petition is not granted is not immediate, direct or obvious.

Unitil argues that its petition is consistent with the deferral granted in *Unitil Energy Systems, Inc.*, Order No. 24,107 in DE 02-221, 87 NH PUC 873 (December 31, 2002) (Commission authorized Unitil to change its accounting for employee pension costs, treating new minimum liabilities relating to the plan as a regulatory asset). In that proceeding, Unitil stated that unless its request was granted, it would be forced to immediately reduce common equity by \$9.8 million, which would have decreased its current equity ratio from 35 percent to 27 percent. Staff testified that such a reduction could have caused Unitil to violate its loan covenants. Hearing Transcript at 162. We agree with Staff that the magnitude of the harm at stake in DE 02-221 was much greater than that alleged to be present in this proceeding. The harm was also much more direct and immediate than the amorphous "negative signals" alleged to be of concern in this proceeding.

Even assuming that Unitil demonstrated the existence of extraordinary circumstances, in the context of its refined proposal, it has not demonstrated why the level of recovery in the near and medium term should be expected to allow the regulatory asset to be paid down. For example, Unitil did not introduce evidence of a change in plan management or managers or investment strategy. Instead, it relied on its assertion that it is probable that the

returns in future years will be higher. That is a possibility, of course, but it is not a sufficient basis to approve the request. If it turned out that pension expense did not become pension income again in the near to medium term, Unitil would be faced with the possibility of writing off the regulatory asset for which authorization is being sought and at that time it would suffer the financial harm it seeks to avoid.

Based upon the foregoing, it is hereby

ORDERED, that Unitil Energy Service's petition for an accounting order is
DENIED.

By order of the Public Utilities Commission of New Hampshire this seventh day
of April, 2005.

Thomas B. Getz
Chairman

Graham J. Morrison
Commissioner

Michael D. Harrington
Commissioner

Attested by:

Debra A. Howland
Executive Director & Secretary