

**BEFORE THE
PUBLIC UTILITY COMMISSION OF RHODE ISLAND**

**BLOCK ISLAND POWER)
COMPANY) DOCKET NO. 3655**

**DIRECT TESTIMONY OF
LAFAYETTE K. MORGAN, JR.**

**ON BEHALF OF THE
DIVISION OF PUBLIC UTILITIES & CARRIERS**

APRIL 2005

EXETER

ASSOCIATES, INC.
5565 Sterrett Place
Suite 310
Columbia, Maryland 21044

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BLOCK ISLAND POWER)
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Direct Testimony of Lafayette K. Morgan, Jr.

Introduction and Summary

1
2 Q. WOULD YOU PLEASE STATE YOUR NAME AND BUSINESS ADDRESS?

3 A. My name is Lafayette K. Morgan, Jr. I am a Senior Regulatory Analyst with Exeter
4 Associates, Inc. Our offices are located at 5565 Sterrett Place, Columbia, Maryland
5 21044. Exeter is a firm of consulting economists specializing in issues pertaining to
6 public utilities.

7 Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND
8 QUALIFICATIONS.

9 A. I received a Master of Business Administration degree from The George Washington
10 University. The major area of concentration for this degree was Finance. I received a
11 Bachelor of Business Administration degree with concentration in Accounting from
12 North Carolina Central University. I am also a Certified Public Accountant licensed in
13 the State of North Carolina.

14 Q. WOULD YOU PLEASE DESCRIBE YOUR PROFESSIONAL EXPERIENCE?

15 A. From May 1984 until June 1990, I was employed by the North Carolina Utilities
16 Commission - Public Staff in Raleigh, North Carolina. I was responsible for analyzing
17 testimony, exhibits, and other data presented by parties before the North Carolina
18 Utilities Commission. I had the additional responsibility of performing the examinations
19 of books and records of utilities involved in rate proceedings and summarizing the results

1 into testimony and exhibits for presentation before that Commission. I was also involved
2 in numerous special projects, including participating in compliance and prudence audits
3 of a major utility and conducting research on several issues affecting natural gas and
4 electric utilities.

5 From June 1990 until July 1993, I was employed by Potomac Electric Power
6 Company (Pepco) in Washington, D.C. At Pepco, I was involved in the preparation of
7 the cost of service, rate base and ratemaking adjustments supporting the company's
8 requests for revenue increases in the State of Maryland and the District of Columbia. I
9 also conducted research on several issues affecting the electric utility industry for
10 presentation to management.

11 In July 1993, I accepted my current position with Exeter Associates, Inc. Since
12 then, I have been involved in the analysis of the operations of public utilities, with
13 particular emphasis on utility rate regulation. I have also been involved in the review and
14 analysis of utility rate filings, focusing primarily on revenue requirements determination.
15 This work has involved natural gas, water, electric and telephone companies.

16 Q. HAVE YOU PREVIOUSLY TESTIFIED IN REGULATORY PROCEEDINGS
17 ON UTILITY RATES?

18 A. Yes. I have previously presented testimony and affidavits on numerous occasions before
19 the North Carolina Utilities Commission, the Pennsylvania Public Utility Commission,
20 the Virginia Corporation Commission, the Louisiana Public Service Commission, the
21 Georgia Public Service Commission, the Maine Public Utilities Commission, the
22 Kentucky Public Service Commission, the Public Utilities Commission of Rhode Island,
23 the Vermont Public Service Board, the Illinois Commerce Commission and the Federal
24 Energy Regulatory Commission (FERC).

25 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

1 A. Exeter Associates has been retained by the Division of Public Utilities and Carriers (the
2 Division) to review the reasonableness of the level of revenues that Block Island Power
3 Company (BIPCo or the Company) is proposing to charge its customers. My assignment
4 in this proceeding was to review BIPCo's cash working capital claim. In this testimony, I
5 present my findings on behalf of the Division relating to BIPCo's cash working capital
6 analysis. I have provided my recommendations to Mr. Thomas S. Catlin, who is also a
7 witness in this proceeding, to incorporate in his revenue requirement determination.
8 Based upon my analysis, BIPCo is entitled to a cash working capital allowance of
9 \$112,640, or \$77,557 less than it included in its filing. My analysis is summarized on
10 Schedules LKM-1 through LKM-6 (attached to this testimony).

11
12 **Allowance for Cash Working Capital**

13 Q. HOW DO YOU DEFINE CASH WORKING CAPITAL?

14 A. For ratemaking purposes, cash working capital is the investment which a utility needs to
15 have on hand to fund its day-to-day operations. Positive cash working capital represents
16 funds provided by investors which should be included in rate base so that the Company
17 earns a return on it. Negative cash working capital represents ratepayer supplied funds
18 which should be recognized as a rate base offset.

19 Q. HOW DID THE COMPANY REFLECT CASH WORKING CAPITAL IN ITS
20 FILING?

21 A. The Company's cash working capital allowance is calculated based upon the results of a
22 lead-lag study. A lead-lag study is an in-depth analysis that measures the difference
23 between the lapse of time when the Company receives revenue for the provision of
24 service and the lapse of time when the Company pays for the costs of providing service.
25 This difference, expressed as a number of days, is used to calculate the level of investor

1 funds advanced for operations if the difference is positive. If the difference is negative, it
2 is used to calculate the funds advanced by customers.

3 The revenue lag represents the average number of days from the date on which
4 service is provided to the customers until the date on which payment is received from the
5 customers. It is measured from the midpoint of the service period covered by the bill to
6 the date payment for that service is received by the Company. The Company's expense
7 lag represents the average number of days from the date the expense is incurred in
8 rendering service until the date the expense is paid.

9 After both the Company's revenue lag and expense payment lag have been
10 determined, one can make a reasonable approximation of the Company's cash working
11 capital requirement. This calculation is made by dividing the expenses by 365 days to
12 determine the average daily amount. The average daily amount is multiplied by the net
13 lead-lag days (the difference from subtracting the expense lag from the revenue lag) to
14 derive the Company's working capital requirements. If the total working capital
15 requirement is positive, it represents a level of funds that the investors must advance for
16 operations. If the amount is negative, then it is the customers who have advanced the
17 funds.

18 Q. PLEASE DEFINE THE TERMS "LEAD" AND "LAG" AS YOU USE THEM
19 IN YOUR TESTIMONY.

20 A. The term "lead" is used to indicate either the receipt of revenue prior to the date that
21 service is provided or the payment of an expense prior to the date that the expense is
22 incurred. The term "lag" is used to indicate either the receipt of revenue after the date
23 that service is provided or the payment of an expense after the date that the expense is
24 incurred.

1 Q. WHAT CONCERNS DO YOU HAVE WITH REGARD TO BIPCO'S CASH
2 WORKING CAPITAL?

3 A. BIPCo's cash working capital is presented on Schedule DGB-6, which is attached to the
4 direct testimony of David G. Bebyn. According to that schedule, the Company has a
5 working capital requirement of \$190,197. However, there are several concerns that I
6 have with the manner in which the working capital was calculated. Therefore, I believe it
7 is necessary to make adjustments in order to properly state the working capital
8 requirement.

9 First, the Company calculated the cash working capital based upon the adjusted
10 test year cost of service rather than the rate year cost of service that is being used to set
11 rates in this proceeding. As a result, the working capital is misstated because the cost of
12 service components for which working capital is being calculated are not stated at the
13 level that the Company is expected to incur during the rate effective period.

14 My second concern is that BIPCo's calculation of the cash working capital
15 overstates the working capital requirement because, although the Company has stated that
16 it removed certain expenses from the cash working capital calculation, the procedure
17 used by BIPCo to calculate working capital, in effect, resulted in including those
18 expenses in the cash working capital at the revenue lag, as I will explain later in this
19 testimony.

20 Finally, I disagree with the number of lag days calculated by BIPCo for certain
21 components of the cost of service. As calculated by the Company, those lag days either
22 exclude the service period component from the lag days or include a normalizing
23 adjustment that is not representative of the Company's operations.

1 **Rate Year Cost of Service**

2 Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO REFLECT THE RATE YEAR
3 COST OF SERVICE COMPONENTS.

4 A. BIPCo's revenue requirement has been calculated based upon the rate year ending May
5 31, 2006. As a result, revenues, expenses and plant have been included at the level
6 expected to be in place during that rate effective period. However, as stated earlier, the
7 Company has used the cost components from the May 31, 2004 adjusted test year in the
8 cash working capital. This approach is inappropriate for two reasons. First, it is
9 inconsistent with the other components of the cost of service, and results in a mismatch of
10 costs. The second reason is that, in order to properly reflect the cost of service, the
11 working capital study should be calculated based upon the costs that the Company will be
12 incurring when the new rates are in effect. According to the Company's filing, the May
13 31, 2004 adjusted test year is not representative of the rate effective period.

14 On Schedule LKM-2, I have used the rate year expenses presented on Schedule
15 WEE-3, which is sponsored by Company witness Walter Edge, as the basis for the O&M
16 expense component of the cash working capital analysis. Those expenses were then
17 adjusted to reflect the recommendations of the Mr. Catlin relating to operating expenses.
18 Consistent with Mr. Bebyn's testimony, I have also removed non-cash expenses from the
19 lead-lag analysis.

20
21 **Working Capital Overstatement**

22 Q. YOU MENTIONED THAT BIPCO OVERSTATED ITS CASH WORKING
23 CAPITAL BECAUSE OF THE PROCEDURE USED TO EXCLUDE CERTAIN
24 EXPENSES FROM THE WORKING CAPITAL ANALYSIS. HOW HAVE
25 YOU CORRECTED THE OVERSTATEMENT?

1 A. BIPCo derived its cash working capital by separately calculating the working capital
2 components (dollar days) for revenue and expenses. The Company then subtracted the
3 expense dollar days from the revenue dollar days to derive the net working capital
4 requirement. A review of the working capital calculation reveals that certain expenses
5 were not properly excluded in the determination of the expense dollar days. As a result,
6 the effect of the Company's working capital analysis was that those expenses that BIPCo
7 attempted to remove from the working capital study were included and lagged based on
8 the revenue lag days.

9 This occurred because in calculating the net working capital, Mr. Bebyn used
10 revenue dollar days based upon total revenues, but subtracted expense dollar days that
11 excluded certain expenses. In the lead-lag study, the result of this calculation is the
12 equivalent of including the revenues related to those expenses at the revenue lag, and
13 subtracting the expenses lagged at zero lag days (which is 0 (zero) dollar days). The net
14 working capital requirement that remains is the expenses lagged at the revenue lag days.

15 Since working capital provides the funds necessary to meet the expenses of day-
16 to-day operations of a company, it is the operating expenses that require cash outlay that
17 should be the basis of the working capital study. The approach I have used to calculate
18 the working capital does that because it provides working capital for only those expenses
19 that require cash. It applies the net lag days to the average daily cash expenses to derive
20 the working capital component. The net lag days is derived by subtracting the average
21 expense lag from the average revenue lag. This approach ensures that for every expense
22 for which working capital is provided, the associated revenues have also been recognized
23 in the calculation. If the net lag days are positive, it means that working capital must be
24 provided through rates for that expense. On Schedule LKM-2, I present this calculation
25 which shows that the Company's working capital requirement is \$112,640.

Lag Day Recalculation

1
2 Q. PLEASE IDENTIFY THE LAG DAYS CALCULATED BY BIPCO WITH
3 WHICH YOU DISAGREE, AND EXPLAIN WHY YOU HAVE
4 RECALCULATED THOSE LAG DAYS.

5 A. I disagree with the number of lag days calculated for operating expenses, gross receipts
6 tax and the revenue lag days.

7 With regard to operating expenses, I believe the 15 lag days used by the Company
8 only recognized the time it takes for the Company to pay its expenses. However, BIPCo
9 receives the products or services prior to being billed. Hence, it is appropriate to include
10 a lag for the period over which the service is received. In my calculation of service
11 period lag, I have assumed that services were received evenly throughout the prior
12 month. Consistent with traditional ratemaking practice, I have used a service period of
13 15.21 days as the average service period. The 15.21 days is the average mid-point of the
14 month, and it recognizes that some services are provided earlier in month and some are
15 provided later in the month. The inclusion of the 15.21 days results in a total average
16 expense lag of 30.21 days. This calculation is presented Schedule LKM-3.

17 My recalculation of the revenue lag days is similar to the expense lag
18 recalculation. From my review of the Company's revenue lag calculation, it was
19 apparent that the Company had not accounted for the service lag to its customers. In fact,
20 the Company confirmed this in its response to Division Data Request No. 1-7. As a
21 result, I have included an average service period lag of 15.21 days to the revenue lag day
22 calculation. The resulting total average revenue lag of 43.71 days is presented on
23 Schedule LKM-6.

24 Finally, I have recomputed the lag days assigned to gross receipts tax to reflect
25 the lag in the payment of the final installment of the gross receipts tax for each tax year.

1 According to the Company's response to Division Data Request No. 1-8, there is a tax
2 payment true-up (shortfall) that is paid after the end of each tax year. However, in its
3 cash working capital analysis, BIPCo calculated the gross receipts tax lead days as if the
4 total amount were paid during the tax year. In fact, however, two estimated payments are
5 made during the tax year and a true-up is paid in March of the year following the related
6 tax year to cover any shortfall from the estimated payments. Therefore, on Schedule
7 LKM-4, I have recalculated the gross receipts tax lead days to reflect the payment of the
8 final tax installment that occurs in March of the year following the related tax year.

9 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

10 A. Yes, it does.
11
12

**BEFORE THE
PUBLIC UTILITY COMMISSION OF RHODE ISLAND**

**BLOCK ISLAND POWER)
COMPANY) DOCKET NO. 3655**

**SCHEDULES ACCOMPANYING THE
DIRECT TESTIMONY OF
LAFAYETTE K. MORGAN, JR.**

**ON BEHALF OF THE
DIVISION OF PUBLIC UTILITIES & CARRIERS**

APRIL 2005

EXETER

ASSOCIATES, INC.
5565 Sterrett Place
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Columbia, Maryland 21044

BLOCK ISLAND POWER COMPANY

Cash Working Capital Summary
Rate Year Ending May 31, 2006

	<u>Amount</u>	
Cash Working Capital per Division	\$ 112,640	
Cash Working Capital per Company	<u>190,197</u>	(1)
Adjustment to Cash Working Capital	<u>\$ (77,557)</u>	

Notes:

(1) Schedule DGB-6.

BLOCK ISLAND POWER COMPANY

Calculation of Operating Expenses Working Capital
Rate Year Ending May 31, 2006

	Rate Year Amount	Division Adjustments	Net Amount	Average Daily Expense	Revenue Lag Days (2)	Expense Lag Days	Net Lag Days	Cash Working Capital
Fuel Expenses	\$ -	\$ - (1)	\$ -	\$ -	43.71	30.21 (3)	13.50	\$ -
Operating & Maintenance Expenses	1,251,659	(193,929)	1,057,730	2,898	43.71	30.21 (3)	13.50	39,126
Payroll	422,943	(23,475)	399,468	1,094	43.71	4.50 (4)	39.21	42,913
General Insurance	119,919	(8,606)	111,313	305	43.71	30.21 (3)	13.50	4,118
Bad Debt	6,330	(6,330)	-	-	43.71	- (3)	43.71	-
Depreciation	256,761	(256,761)	-	-	43.71	-	43.71	-
Total Taxes other than GRT & Deferred Taxes	97,970	2,890	100,860	276	43.71	30.21 (3)	13.50	3,731
Deferred Taxes	18,382	(18,382)	-	-	43.71	- (3)	43.71	-
Gross Receipts Taxes	84,370	7,766	92,136	252	43.71	(41.19) (5)	84.90	21,432
Interest Expense	209,431	(16,624)	192,807	528	43.71	41.21 (6)	2.50	1,321
	<u>\$ 2,467,765</u>	<u>\$ (513,451)</u>	<u>\$ 1,954,314</u>					<u>\$ 112,640</u>

Notes:

- (1) Per Response to Division 1-2, fuel adjustment clause contain a separate financing cost factor.
- (2) Schedule 7.
- (3) Schedule 3.
- (4) Schedule DGB-6c.
- (5) Schedule 4.
- (6) Schedule 5.

BLOCK ISLAND POWER COMPANY

Calculation of Operating Expenses Payment Lag
Rate Year Ending May 31, 2006

Number of days per Year	365
Number of Month per Year	<u>12</u>
Average number of days per month	30.42
Service Period Divisor	<u>2</u>
Average Service Period Number of Days	15.21 (1)
Payment Lag Days	<u>15.00 (2)</u>
Operating Expense Payment Lag	<u><u>30.21</u></u>

Notes:

- (1) To reflect service period lag.
- (2) Schedule DGB-6.

BLOCK ISLAND POWER COMPANY

Calculation of Average Gross Receipts Tax Lead Days
Rate Year Ending May 31, 2006

	<u>GRT Accrued</u>
2002 GRT Lead Days	50 (1)
2003 GRT Lead Days	<u>33 (2)</u>
Average GRT Lead (Days)	<u><u>41</u></u>

Notes:

- (1) Schedule 4, page 2.
- (2) Schedule 4, page 3.

BLOCK ISLAND POWER COMPANY

Calculation of 2002 GRT Lead/Lag Days
Rate Year Ending May 31, 2006

	<u>2002 Revenue</u>	<u>2002 GRT Accrued</u>	<u>2002 GRT Paid</u>	<u>GRT (Payable) / Prepaid</u>
January-02	\$ 125,433.16	\$ 5,017.33	\$ -	\$ (5,017.33)
February-02	102,574.09	4,102.96	-	(9,120.29)
March-02	116,268.69	4,650.75	41,524.00 (1)	27,752.96
April-02	118,651.44	4,746.06	-	23,006.90
May-02	139,464.67	5,578.59	-	17,428.31
June-02	347,661.07	13,906.44	62,286.00 (1)	65,807.87
July-02	443,306.05	17,732.24	-	48,075.63
August-02	444,793.37	17,791.73	-	30,283.90
September-02	368,174.30	14,726.97	-	15,556.93
October-02	162,679.39	6,507.18	-	9,049.75
November-02	149,528.10	5,981.12	-	3,068.63
December-02	141,487.43	5,659.50	-	(2,590.87)
January-03	-	-	-	(2,590.87)
February-03	-	-	-	(2,590.87)
March-03	-	-	2,590.87 (2)	(0.00)
	<u>\$ 2,660,021.76</u>	<u>\$ 106,400.87</u>	<u>\$ 106,400.87</u>	<u>\$ 218,120.65</u>
Average Monthly GRT				\$ 14,541.38
Total Annual GRT				\$ 106,400.87
Prepaid Percentage				14%
Annual Number of Days				365
2002 GRT Lead Days				<u>50</u>

Notes:

- (1) Per Response to Division 1-8, These are the actual amounts paid in March & June. The Company adjusted these amounts as if no true-up (or shortfall) occurred after year-end.
(2) Per Response to Division 1-8, The shortfall is due on or before the subsequent March 1st.

BLOCK ISLAND POWER COMPANY

Calculation of 2003 GRT Lead/Lag Days
 Rate Year Ending May 31, 2006

	<u>2003 Revenue</u>	<u>2003 GRT Accrued</u>	<u>2003 GRT Paid</u>	<u>GRT (Payable) / Prepaid</u>
January-03	\$ 143,975.46	\$ 5,759.02	\$ -	\$ (5,759.02)
February-03	154,452.25	6,178.09	-	(11,937.11)
March-03	132,935.79	5,317.43	43,380.00 (1)	26,125.46
April-03	150,597.14	6,023.89	-	20,101.57
May-03	209,200.04	8,368.00	-	11,733.57
June-03	349,729.63	13,989.19	65,070.00 (1)	62,814.38
July-03	473,124.56	18,924.98	-	43,889.40
August-03	539,037.93	21,561.52	-	22,327.88
September-03	308,949.11	12,357.96	-	9,969.92
October-03	162,994.84	6,519.79	-	3,450.13
November-03	149,550.45	5,982.02	-	(2,531.89)
December-03	140,440.87	5,617.63	-	(8,149.52)
January-04	-	-	-	(8,149.52)
February-04	-	-	-	(8,149.52)
March-04	-	-	8,149.52 (2)	0.00
	<u>\$ 2,914,988.07</u>	<u>\$ 116,599.52</u>	<u>\$ 116,599.52</u>	<u>\$ 172,034.77</u>
Average Monthly GRT				\$ 10,382.38
Total Annual GRT				\$ 116,599.52
Prepaid Percentage				9%
Annual Number of Days				365
2003 GRT Lead Days				<u>33</u>

Notes:

- (1) Per Response to Division 1-8, These are the actual amounts paid in March & June. The Company adjusted these amounts as if no true-up (or shortfall) occurred after year-end.
 (2) Per Response to Division 1-8, The shortfall is due on or before the subsequent March 1st.

BLOCK ISLAND POWER COMPANY

Calculation of Average Interest Lag
 Rate Year Ending May 31, 2006

	<u>Amount</u>	<u>Lag Days</u>	<u>Weighted Amount</u>
RUS Debt	\$ 3,078,109	45.00 (1)	\$ 138,514,905
Non-RUS Debt	<u>1,060,412</u>	30.21 (2)	<u>32,033,279</u>
	<u>\$ 4,138,521</u>		<u>\$ 170,548,184</u>
Average Lag Days		<u>41.21</u>	

Notes:

- (1) Service Period Days 90 Per response to Division 1-6, RUS debt is paid quarterly.
 Divisor 2
 Lag Days 45.00 Midpoint of # of days in quarter to end of quarter.
- (2) Per Response to Division 1-6, WTC loan is paid monthly on the 15th of each month. Therefore, there is a 30-day service period and a 15-day payment lag that results in 15.21 lag days from midpoint of the service period to the end plus the 15-day payment lag.

BLOCK ISLAND POWER COMPANY

Calculation of Average Revenue Lag Days
Rate Year Ending May 31, 2006

	<u>Lag Days</u>
Average Monthly Service Period Days	15.21 (1)
Billing Lag Days	15.00 (2)
Collection Lag Days	<u>13.50 (2)</u>
Average Revenue Lag Days	<u><u>43.71</u></u>

Notes:

- (1) Schedule 3.
- (2) Schedule DGB-6a.