October 22, 2004

Luly Massaro
Clerk
Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

Re: Docket 3548

Dear Luly,

Enclosed are ten (10) copies of the testimony of David Effron on behalf of the Division of Public Utilities and Carriers relative to the Earnings Sharing component of the DAC. The Division is awaiting certain additional information from the Company as follow-up to our second set of data requests. The testimony will be revised, if necessary, as a result of additional information to be provided by New England Gas.

Sincerely,

Stephen Scialabba
Chief Accountant

Cc: service list

NEW ENGLAND GAS COMPANY

DISTRIBUTION ADJUSTMENT CLAUSE FILING

RIPUC DOCKET NO. 3548

BEFORE THE
RHODE ISLAND PUBLIC UTILITIES COMMISSION

TESTIMONY AND EXHIBITS
OF DAVID J. EFFRON

ON BEHALF OF THE

DIVISION OF
PUBLIC UTILITIES AND CARRIERS

OCTOBER 22, 2004

RIPUC DOCKET NO. 3548
DIRECT TESTIMONY
OF DAVID J. EFFRON

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I. STATEMENT OF QUALIFICATIONS

Q. Please state your name and business address.

A. My name is David J. Effron. My business address is 386 Main Street, Ridgefield, Connecticut.

Q. What is your present occupation?

A. I am a consultant specializing in utility regulation.

Q. Please summarize your professional experience.

A. My professional career includes over twenty-five years as a regulatory consultant, two years as a supervisor of capital investment analysis and controls at Gulf & Western Industries and two years at Touche Ross & Co. as a consultant and staff auditor. I am a Certified Public Accountant and I have served as an instructor in the business program at Western Connecticut State College.

Q. What experience do you have in the area of utility rate setting proceedings?

A. I have analyzed numerous electric, gas, telephone, and water filings in different jurisdictions. Pursuant to those analyses I have prepared testimony, assisted attorneys in case preparation, and provided assistance during settlement negotiations with various utility companies.

I have testified in over two hundred cases before regulatory commissions in Alabama, Colorado, Connecticut, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Missouri, Nevada, New Jersey, New York, North Dakota, Ohio, Pennsylvania, Rhode Island, South Carolina, Texas, Vermont, and Virginia.

Q. Please describe your other work experience.

A. As a supervisor of capital investment analysis at Gulf & Western Industries, I was responsible for reports and analyses concerning capital spending programs, including project analysis, formulation of capital budgets, establishment of accounting procedures, monitoring capital spending and administration of the leasing program. At Touche Ross & Co., I was an associate consultant in management services for one year and a staff auditor for one year.

Q. Have you earned any distinctions as a Certified Public Accountant?

A. Yes. I received the Gold Charles Waldo Haskins Memorial Award for the highest scores in the May 1974 certified public accounting examination in New York State.

Q. Please describe your educational background.

A. I have a Bachelor's degree in Economics (with distinction) from Dartmouth College and a Masters of Business Administration Degree from Columbia University

II. PURPOSE AND SUMMARY OF TESTIMONY

Q. On whose behalf are you testifying?

A. I am testifying on behalf of the Rhode Island Division of Public Utilities and Carriers ("the Division").

Q. What is the purpose of your testimony?

A. On September 3, 2004, New England Gas Company ("NEG" or "the Company") filed its calculation of the Earnings Sharing Factor pursuant to the Commission's approval of the incentive based Earnings Sharing Mechanism ("ESM") contained in the Settlement Agreement in Docket 3401 ("Settlement"). The ESM Factor is a credit to the recoveries through the Distribution Adjustment Clause ("DAC"). The purpose of this testimony is to address the development of the ESM Factor to be included in the DAC.

Q. Please summarize your testimony.

A. Based on my review and analysis of information provided by the Company, I have calculated that for the twelve months ended June 30, 2004, NEG earned $450,000 of excess revenue to be credited to the DAC. This determination of excess revenue is subject to adjustment based on the receipt of data requests to the Company outstanding at the time of the preparation of this testimony.

III. ESM CALCULATION

Q. Please describe the ESM Factor of the DAC.

A. The Settlement established a mechanism for sharing any annual earnings in excess of 11.25% for the period July 1, 2002 through June 30, 2005 between customers and investors. In particular, Section II.F.5 of the Settlement specifies that:

> Any annual earnings over 11.25%, up to and including 100 basis points, shall be shared 50% to customers and 50% to the Company.

> Any earnings in excess of 12.25% shall be shared 75% to customers and 25% to the Company. In calculating the earnings subject to the ESM on an annual basis, the benchmark will remain at 11.25%, unless modified in a subsequent proceeding setting base rates to be effective on or after July 1, 2005. The customer share of any excess earnings will be passed through as a credit to the DAC.

Q. Did the Settlement specify how the return on equity should be calculated for the purpose of determining whether there were excess earnings to be credited to the DAC?

A. Yes. Section II.F.1 of the Settlement states:

> The return on common equity will be calculated by dividing the net income available for common equity by the common equity applicable to rate base; where the net income available for common equity is equal to operating income adjusted to reflect Commission ratemaking principles less applicable interest and preferred dividends (if any) …

Q. Has the Company prepared an analysis of its earned return on common equity for the twelve months ended June 30, 2004 ("FY2004")?

A. Yes. The Company calculated that earned a return on common equity of 11.64% in FY2004, resulting in a refund to customers of $314,000.

Q. Have you examined the analysis conducted by the Company?

A. Yes. I have reviewed the return on common equity ("ROE) presented by the Company in Attachment RJR-1 to the direct testimony of Mr. Riccitelli. My examination included an analysis of the Company's financial statements for the twelve months ended June 30, 2004, workpapers supporting the return on equity calculation, and responses to requests for information by the Division.

Q. Based on your examination, should the Company's calculation of its earned ROE for FY2004 be modified?

A. Yes. There should be certain modifications to the Company's calculation of the earned return on common equity. My proposed modifications affect the determination of net income and the determination of common equity supporting rate base.

Q. Have you recalculated the earned return on equity and the ESM factor with your proposed modifications?

A. Yes. My calculation of the return on common equity earned by NEG in FY2004 is summarized on my Schedules DJE-1 and DJE-2. Schedule DJE-1 is a summary of the earned return on equity and the ESM Factor of the DAC. Schedule DJE-2 is my calculation of the net income and rate base to be used in the calculation of the earned return on equity.

Q. Please explain Schedule DJE-2, Page 1.

A. On Schedule DJE-2, Page 1, I have begun in the first column with the net income available for common equity as calculated by the Company. In the next column, I show my proposed adjustments; and in the third column, I show my calculation of the net income available for common equity. The adjustments to income are summarized Schedule DJE-2, Page 2.

Q. What is your first proposed adjustment to operating income, related to gain on the sale of property?

A. In FY2004, NEG realized a $162,000 gain on the disposition of property. This gain was credited to Account 421.1, a non-operating income, or "below the line" account, and was not included by the Company in its calculation of net income for the purpose of earnings sharing. NEG explained that this was treated as non-operating income because the disposed property was not subject to composite depreciation rules.

The Company subsequently clarified that although the property was not subject to composite depreciation rules, it had been utility property prior to its disposition. As the property had been utility property and subject to recovery through the cost of service, the gain on the disposition of that property should be included in the determination of income for the purpose of calculating earnings sharing. Therefore, I have increased fiscal year 2004 revenues to recognize the gain on the disposition of utility property of $162,000.

Q. What is your next adjustment to income, related to the interest on the Conservation Loan Program?

A. The Company has included the interest on the Conservation Loan Program in the "Other Interest Expense" deducted from net operating income in the calculation of net income. The interest on the Conservation Loan Program represents interest accrued on a credit balance of non-investor supplied funds. As the credit balance of non-investor supplied funds itself is not deducted from rate base, to be consistent, the interest on that credit balance should not be deducted from net operating income in the calculation of net income. The elimination of the interest on the Conservation Loan Program reduces "Other Interest Expense" by $20,000. As I explain later, the elimination of the interest on the Conservation Loan Program also affects the Company's FY2003 compliance filing.

Q. What net income for available for common equity have you calculated?

A. I have calculated net income available for common equity of $12,378,000 (Schedule DJE-2, Page 1) for FY2004. This is the amount that should be divided by the balance of common equity applicable to rate base to determine the earned return on equity.

Q. Does the Settlement specify how the balance of common equity used in the earned return calculation should be determined?

A. Yes. Section II.F.1 of the Settlement states that in determining the earned return on equity:

> The common equity applicable to rate base shall be calculated by multiplying the actual common equity ratio, subject to the limitations in paragraph 2 below, by rate base. The rate base used in these calculations will be the average rate base for the relevant period, based on a five-quarter average and established Commission ratemaking principles.

Paragraph II.F.2 referred to in that section specifies that a common equity ratio of 43.6% will be used to calculate the common equity applicable to rate base during the Rate-Freeze period, July 1, 2002 – June 30, 2005.

Q. Are you proposing any adjustments to the rate base calculated by the Company for the purpose of determining the common equity balance to be used in the return on common equity calculation?

A. Yes. My calculation of rate base is shown on Schedule DJE-2, Page 3. My proposed adjustments to the rate base presented by the Company are summarized on Schedule DJE-2, Page 4.

Q. What is your proposed adjustment to the amount of prepayments included in rate base?

A. One of the items included in the prepayments is the "prepaid" PUC assessment. As explained by the Company, this so-called prepayment is not actually paid until the third quarter of its fiscal year. However, the Company begins accruing for this expense at the beginning of the fiscal year and then charges the actual payment against the accrued liability when the payment is made, in the third quarter. Thus, the payment for this expense actually takes place in arrears of when recognition of the expense commences, not in advance.

In calculating the average balance of prepayments, the Company reflected the PUC assessment as a prepayment in the third quarter of the fiscal year (response to Division Information Request 2-11). This is incomplete. The average balance should also reflect the balance of the accrual for the PUC assessment in advance of the time that it is paid. On Schedule DJE-2, Page 4, I have calculated the average balance of the PUC assessment liability or prepayment, assuming that the expense is accrued evenly over the course of the fiscal year. The average balance is $(82,000), which is $133,000 less than the average balance calculated by the Company. Accordingly, I have reduced the prepayments included in rate base by $133,000.

Q. What is your next adjustment to rate base on Schedule DJE-2, Page 4, related to accumulated deferred income taxes (ADIT)?

A. Referring to Company Attachment RJR-1, Page 5, it can be seen that the Company does not adjust the balance of ADIT existing at the beginning of the fiscal year until the end of the fiscal year. This does not properly reflect the actual accrual of ADIT over the course of the year and distorts the calculation of the average balance of ADIT.

On Schedule DJE-2, Page 4, I have recalculated the average balance of ADIT. The balance of ADIT as of June 30, 2004 reflects a true-up of the FY2003 deferred taxes. As this adjustment relates to fiscal year 2003, it should be added to the ADIT as of June 30, 2003 for the purpose of calculating the average balance. The fiscal year 2004 accrual for deferred taxes was $2,957,000. For the purpose of calculating the average balance, I have assumed that this addition to ADIT accrued evenly over the year, and I added one-quarter of the annual accrual in each quarter to calculate the balance of ADIT as of the end of each quarter. My modifications result in average balance of ADIT of $32,271,000. This is $1,019,000 greater than the average balance calculated by the Company.

Q. Should the method of calculating any the five-quarter average of any other component rate base also be modified?

A. Yes. In response to Division Information Request 2-13, the Company noted that the method of calculating the average balance of ADIT is consistent with the cash working capital calculation. Thus, the method of calculating the cash working capital balance in rate base should also be modified. The determination of cash working capital for the twelve months ended June 30, 2004 on Attachment RJR-1, Page 6 reflects the cash working capital requirement over the course of FY2004, based on the expenses incurred over the course of that year. It is not necessary to average that cash working capital requirement with the cash working capital requirement for the prior year to determine the average cash working capital allowance in rate base for FY2004. Rather, the cash working capital for the twelve months ended June 30, 2004 is the amount that should be included in rate base, and I have reflected that amount on my Schedule DJE-2, Page 3.

Q. Please explain your adjustment to rate base related to contributions in aid of construction.

A. Contributions in aid of construction represent cash advances from developers for facilities to be constructed by the Company. When the funds for construction are actually expended, the contributions are credited against the cost of the plant. Until the funds are expended, the contributions represent non-investor, zero cost capital to the Company. As such, the contributions in aid of construction should be deducted from rate base. On my Schedule DJE-2, Page 3, I have reflected balance of contributions in aid of construction as of June 30, 2004, $885,000, as a rate base deduction. This balance will be revised when the Company provides data regarding the quarterly balances of contributions in aid of construction in FY2004.

Q. With your proposed adjustments, what rate base have you calculated?

A. I have calculated a rate base of $240,419,000 (Schedule DJE-2, Page 3).

Q. What balance of common equity have you calculated?

A. Applying the common equity ratio of 43.6% to the rate base of $240,419,000, I have calculated a balance of common equity of $104,823,000.

Q. With the above changes to the net income available for common equity and the balance of common equity, what return on equity have you calculated for FY2004?

A. With the modifications described above, I have calculated that NEG Gas earned 11.81% return on common equity in FY2004 (Schedule DJE-1).

Q. Have you also calculated the excess revenue based on this earned ROE?

A. Yes, I have calculated excess revenue of $450,000 on Schedule DJE-1. This calculation is in the same format as Appendix C to the Settlement.

Q. Have you incorporated any other adjustments to the excess revenue to be refunded to customers?

A. Yes. The Company calculated incremental earnings of $76,000 from the FY2003 compliance filing to be added to the FY2004 earnings to be credited to the DAC. I have adjusted the incremental earnings from the fiscal year 2003 compliance filing to eliminate $31,000 of interest on the Conservation Loan Program, for the reasons explained above. As the Company was in the 75% sharing bracket in fiscal year 2003, increasing pre-tax earnings by $31,000 increases the amount to be refunded by $23,000 (75%*$31,000), from $76,000 to $99,000. I have added this $99,000 to the fiscal year 2004 excess earnings, resulting in total earnings to be refunded of $549,000.

Q. Have you also calculated the ESM Factor to be included in the DAC based on this level of excess earnings?

A. Yes. Based on sales of 355,694,000 therms, the ESM Factor included in the DAC would be $0.0015 per therm (Schedule DJE-1).

Q. Does this conclude your direct testimony?

A. For now, it does. I will supplement this testimony, as necessary, and revise the above calculations when the Company responds to Division's data requests outstanding at the time of the preparation of this testimony.

Schedule DJE-1

NEW ENGLAND GAS COMPANY
CALCULATION OF EARNINGS SHARING
($000)

1	Net Income Available for Common Equity	$ 12,378
2	Common Equity Supporting Rate Base	104,823
3	Earned Return on Common Equity	11.81%
4	Benchmark Return on Common Equity	11.25%
5	Return on Equity above Benchmark	0.56%
6	Earnings above Benchmark	585
7	Company Share of Earnings above Benchmark - 50/50 Sharing	293
8	Company Share of Earnings above Benchmark - 75/25 Sharing	-
9	Ratepayer Share of Earnings above Benchmark	293
10	Revenue to be Refunded	$ 450
11	FY03 Incremental Earnings Credited to DAC	99
12	Total Earnings Credited to DAC	549
13	Firm Throughput (000 Therms)	355,694
14	Earnings Sharing Factor ($/therm)	$ 0.0015

Line Notes

1	Net Income Available for Common Equity		DJE-2, Page 1
2	Rate Base	$240,419	DJE-2, Page 3
	Common Equity Ratio	43.60%	DJE-2, Page 4
	Common Equity Supporting Rate Base	$ 104,823	
3	Line 1 / Line 2		
4	Per Settlement		
5	Line 3 - Line 4		
6	Line 5 * Line 2		
7	Line 5 (up to 1.00%) * Line 2 / 2, not Less than Zero		
8	((Line 5 - 1.00%)*Line 2)/4, not Less than Zero		
9	Line 6 - Line 7 - Line 8		
10	Line 9 /.65 (1- Tax Rate)		
11	Attachment PCC-8, RJR-3, Page 2	76+0.75*31	
12	Line 10 + Line 11		
13	Attachment PCC-8		
14	Line 12 / Line 13		

Schedule DJE-2
Page 1

NEW ENGLAND GAS COMPANY
RESULTS OF OPERATIONS
YEAR ENDED JUNE 30, 2004
($000)

	(1) Company Position	Adjustments		Division Position
Revenue	$ 381,468	$ 162	(2)	$ 381,630
Operation and Maintenance Expense	312,303			312,303
Depreciation and Amortization	19,730			19,730
Other Taxes	20,943			20,943
Income Taxes	6,835	74	(2)	6,909
Operating Expenses	359,811	74		359,885
Operating Income	21,657	88		21,745
Interest on Short-Term Debt	429	(1)	(3)	428
Interest on Long-Term Debt	8,609	(28)	(3)	8,581
Other Interest	153	(20)	(2)	133
AFUDC	(228)	-		(228)
Total Interest Expense	8,963	(49)		8,914
Net Income	12,694	88		12,831
Preferred Dividends	455	(1)	(3)	454
Net Income for Common Equity	$ 12,239	$ 139		$ 12,378

Sources:

(1)	Attachment RJR-1, Page 2			
(2)	Schedule DJE-2, Page 2			
(3)	Rate Base		$240,419	DJE-2, Page 3
	Interest on Short-Term Debt	0.18%	428	DJE-2, Page 5
	Interest on Long-Term Debt	3.57%	8,581	DJE-2, Page 5
	Preferred Dividends	0.19%	454	DJE-2, Page 5

NEW ENGLAND GAS COMPANY
DIVISION ADJUSTMENTS TO INCOME
YEAR ENDED JUNE 30, 2004
($000)

Revenue:			
Gain on Sale of Utility Property	(1)		162
Interest Expense:			
Interest on Conservation Loan Program	(2)		(20)
Income Taxes:			
Revenue	(3)		381,630
Operating Expenses	(3)		352,976
Interest	(3)		8,914
Taxable Income			19,740
Income Tax Expense		35%	6,909

Sources:
(1) Response to DIV 2-14
(2) Response to DIV 2-09
(3) Schedule DJE-2, Page 1

NEW ENGLAND GAS COMPANY
RATE BASE
YEAR ENDED JUNE 30, 2004
($000)

	(1) Company Position	Adjustments		Division Position
Utility Plant in Service	$483,606			$483,606
Less- Reserve for Depreciation	(221,101)			(221,101)
Net Plant	$262,505			$262,505
Add:				
Materials & Supplies	1,723			1,723
Prepaid Expenses	1,027	(133)	(2)	894
Deferred Debits	2,700			2,700
Gas Inventories	-			-
Cash Working Capital	9,851	1,255		11,106
Deduct:				
Accumulated Deferred FIT	(31,252)	(1,019)	(2)	(32,271)
Accumulated Deferred ITC	(1,747)			(1,747)
Contributions in Aid of Construction	-	(885)	(2)	(885)
Customer Deposits	(2,775)			(2,775)
Injury and Damages Reserve	(832)	-		(832)
Rate Base	$241,200	($781)		$240,419

Source:
(1) Attachment RJR-1, Page 5
(2) Schedule DJE-2, Page 4

NEW ENGLAND GAS COMPANY
RATE BASE ADJUSTMENTS
YEAR ENDED JUNE 30, 2004
($000)

Prepaid Assessment			
Balance	Jun-03		-
	Sep-03	(1)	(221)
	Dec-03	(1)	(441)
	Mar-04	(2)	253
	Jun-04		-
	Average		(82)
	Average per Company		51
	Adjustment to Company Position		(133)
Accumulated Deferred FIT			
Balance	Jun-03	(3)	30,792
	Sep-03	(4)	31,531
	Dec-03	(4)	32,271
	Mar-04	(4)	33,010
	Jun-04	(4)	33,749
	Average		32,271
Contributions in Aid of Construction			
Balance	Jun-03	(5)	
	Sep-03	(5)	
	Dec-03	(5)	
	Mar-04	(5)	
	Jun-04	(5)	885
	Average		885

Sources:

(1)	Annual expense of $882 (DIV 2-17, p. 4), accrued over the fiscal year	
(2)	Response to DIV 2-11	
(3)	Attachment RJR-2	30627+165
(4)	Attachment RJR-2	$2,957 accrued over fiscal year
(5)		

NEW ENGLAND GAS COMPANY
RATE OF RETURN

	Ratio	Cost Rate	Wtd. Cost
Short Term Debt	8.80%	2.02%	0.18%
Long Term Debt	45.70%	7.81%	3.57%
Preferred Stock	1.90%	9.93%	0.19%
Common Equity	43.60%	11.25%	4.91%
Total	100.00%		8.84%

Source: Settlement, Section II.F
Attachment RJR-1, Page 10 for Short Term Debt Rate