BEFORE THE
RHODE ISLAND PUBLIC UTILITIES COMMISSION

DOCKET NO. 4323

TESTIMONY OF LEE SMITH

ON BEHALF OF THE
RHODE ISLAND DIVISION OF PUBLIC UTILITIES AND CARRIERS

August 30, 2012

I. INTRODUCTION

Q. What is your name and business address?

A. My name is Lee Smith, and I work for La Capra Associates, One Washington Mall, Boston, MA 02108.

Q. On whose behalf are you testifying in this proceeding?

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

Q. Please describe your background and experience.

A. I am a Managing Consultant and Senior Economist at La Capra Associates. I have been with this energy planning and regulatory economics firm for 28 years. I have prepared testimony on gas and electric rates, rate adjustors, cost allocation and other issues regarding more than 40 utilities in 19 states and before the Federal Energy Regulatory Commission. Prior to my employment at La Capra Associates, I was Director of Rates and Research, in charge of gas, electric, and water rates, at the Massachusetts Department of Public Utilities. Prior to that period, I taught economics at the college level. My resume is attached as Exhibit (LS-1).

Q. Please describe your educational background.

A. I have a bachelor's degree with honors in International Relations and Economics from Brown University. I have completed all requirements except the dissertation for a Ph.D. in economics from Tufts University.

Q. What is the purpose of your testimony?

A. I have been asked by the Division to review the reasonableness and appropriateness of the allocation of costs from affiliates to the Narragansett Electric Company and to Narragansett Gas ("Narragansett" or "Company"). Significant amounts of costs allocated from affiliated companies are reflected in Narragansett's proposed revenue requirement.

I address three issues with regard to affiliate costs:

1. How have corporate costs changed after the mergers?
2. Has the shift in service company costs between utilities been appropriate?
3. Are the total charges from service companies reasonable?

Q. Please summarize your findings regarding these issues.

A. I find the following:

1. The total number of employees associated with corporate functions first increased from 2008 but then decreased to about the premerger level.
2. The shift in affiliate costs results primarily from switching to a consistent allocation methodology that is more appropriate than what it replaced.
3. Service Company costs are not market tested, but rather are based on National Grid centralized policies; I cannot determine whether they are more or less expensive than if they (or some subset of service company activities) were performed in Rhode Island or competitively acquired.

II. IMPACT OF SERVICE COMPANY COSTS ON NARRAGANSETT ELECTRIC AND GAS

Q. Why are service company costs a unique topic for investigation in this case?

A. Service company costs are relevant for two reasons. First, they constitute a very large portion of total distribution costs. Second, there has been a fairly large shift of costs between the Rhode Island electric and gas utilities which needs to be understood.

Q. Where in the proposed revenue requirement are service company costs reflected?

A. Service company costs are reflected in multiple expense and plant costs, as National Grid has centralized many of its operations. The Service Companies provide a long list of services, from corporate, customer service, engineering, administration, financial service, human resources, information technology, legal and regulation, operating services, study and planning of plant facilities, and fuel acquisition, administration and management.. (DIV 11-1 /ELEC/GAS) The major service company facilities are located in Massachusetts and the New York/Long Island region, with a lesser amount in upstate New York. As of December 2011, there were 6318 service company employees, of whom only 109 were located in Rhode Island.

Q. What is the impact of service company costs on Narragansett Electric in this case?

A. A very large portion of Electric Company costs are the result of service company costs charged to it. Of total claimed expenses of $127 million, $42 million are the result of direct and allocated charges from the service companies. Allocated charges alone are $20.5 million, after a reduction of $5.4 million from test year booked costs resulting from a reallocation of service company costs. In addition, the requested revenue requirement includes a negative $2.6 million reflecting projected productivity and efficiency savings from the restructuring program.

Q. What is the impact of service company costs on Narragansett Gas in this case?

A. Of Gas Company total claimed expenses of $92.5 million, $49.7 million are the result of allocated charges from the service companies, after an increase from test year costs of $5.2 million resulting from the reallocation of service company costs. In addition, the requested revenue requirement includes a negative $1.1 million reflecting projected productivity and efficiency savings from the restructuring.

Q. How did the Company address service company costs in this filing?

A. Company witness Michael LaFlamme describes the Company's approach to its total service company costs and supports a significant reallocation of test year booked affiliate costs. One of the results is a decrease in Electric Company costs and an increase in Gas Company costs, compared to test year booked costs. The

Company had outside consultants perform major reviews of service company charges. The purpose of the review was to confirm that the affiliate charges were valid, that they were allocated appropriately according to National Grid's Cost Allocation Policies and Procedures Manual ("CAM"), and that no major errors were contained in the allocations. In addition, the consultants advised on how allocations should be performed consistently among the service companies.

Q. You mentioned an outside review of service company costs. By whom was this analysis of service company costs undertaken?

A. The Company retained Ernst and Young ("EY") to review the accounting of costs charged from the service companies to the Rhode Island utilities in the test year. The Company was also advised by another firm, PA Consulting, on its cost allocation practices and on a methodology to be utilized by the consolidation of service company operations that National Grid is moving towards.

Q. Why were service company costs reviewed and then reallocated between affiliates from the test year booked costs?

A. The review was evidently prompted by inconsistencies among The methods used by the different service companies and by a plan to consolidate service companies. There are four different service companies that provide services to National Grid affiliates. Some services are directly charged, some are identified and allocated by cost causation, and some remain joint costs to be allocated. There were some differences in how costs were directly charged by the affiliates. However, for services that do not directly benefit a specific affiliate, the cost must be allocated. There have been significant differences between the allocation method utilized by the National Grid service company and that used by the KeySpan companies.

The KeySpan and NationalGrid service companies have also different financial accounting systems. National Grid is working to consolidate these systems and to standardize the allocation of service company costs.

Q. What were the results of these analyses of service company costs?

A. The accounting analysis concluded that the affiliate charges were valid, that they were allocated appropriately according to National Grid's Cost Allocation Policies and Procedures Manual ("CAM"), that the allocation adjustments that they found were not material, and there were no facts indicating that costs should be excluded or allocated differently.

With regard to allocation, the PA Consulting analysis recommended a process whereby affiliate companies should be direct charged where costs are directly related to the affiliate, that costs be allocated on cost causative bases where cost causation can be identified, and finally that other costs be allocated on a three-point allocator. This allocator is essentially what has been used by the legacy KeySpan service companies.

Q. Please describe the three-point allocator and the rationale for using this allocator.

A. This allocator weights three components equally; Gross Margin, Net Plant, and O&M Expenses. There are a number of variants of a three-point allocator that use various definitions of revenue, plant and employees or expenses. PA Consulting supports using Gross Margin rather than revenue and O&M expenses rather than employees because of the particular characteristics of the NGrid companies. It notes that a similar allocator is used by a number of the utilities that it has surveyed.

III. CONCLUSIONS REGARDING SERVICE COMPANY COSTS

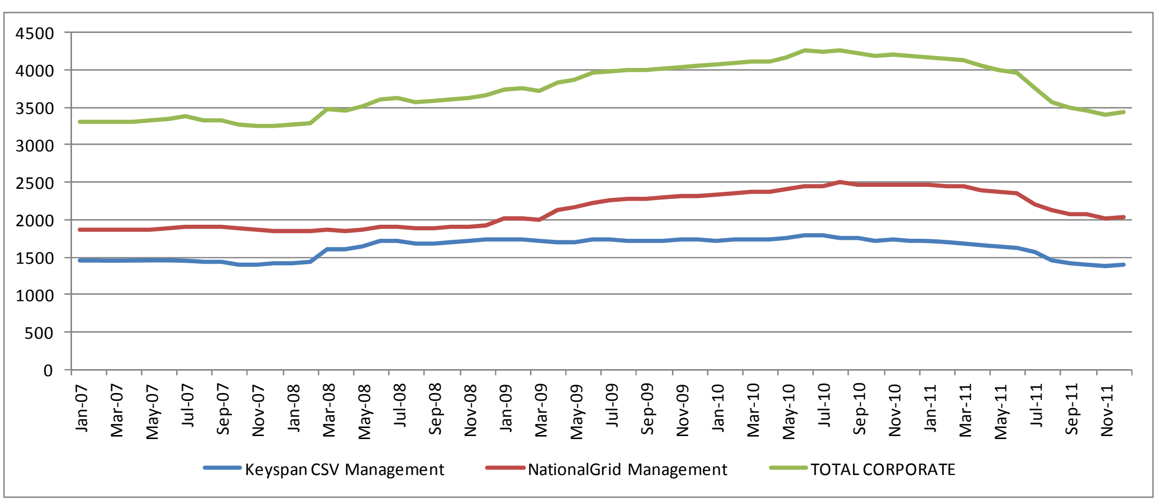
Q. Does the consolidation of the various service company costs provide any benefits to ratepayers?

A. The proposed revenue requirement does not indicate any net benefits to rate payers. The consolidation of the financial systems, referred to as the U.S.

Foundation Program (Division 11-4), is scheduled to result in integration of these systems by October 2012. The Company proposes to capitalize $273.4 million of the cost of this "program", amortized over 10 years, of which Narragansett Electric will be allocated $2.6 million and Narragansett Gas $1.1 million (computer rent expense). (Commission 2-44 GAS/ELEC). It will also be spending an additional $83.3 million which it is not requesting be included in the revenue requirement in this proceeding. The amortization of these capitalized costs is offset by the savings attributed to the consolidation and reflected as a proforma adjustment.

Q. Have service company costs increased unreasonably since the mergers?

A. I have reviewed data on the number of service company employees from 2007 through 2011. The total number of service company employees and of those in the general corporate categories increased from 2008 through the first quarter of 2011, but since that time has decreased significantly. General corporate costs would be the area where I would most expect to see savings from consolidation. I reviewed the total of KeySpan and National Grid service company employees in the categories that constitute corporate costs over five years. The graph below from data provided in DIV 11-1-1 illustrates the increase and then decrease in these numbers.



The Company's proposed revenue requirement associated with service company employee and employee related costs is developed based on the end of 2011, reflecting the decrease depicted above.

The number of employees should be an indicator regarding the change in service company costs, although it does not reflect possible increases in capital costs. Total service company O&M charges provided in DIV 19-1 ELEC/GAS show a dramatic increase from 2007 to 2008, and a 2011 total year cost that is much higher than 2008. These total service company O&M costs, however, include costs associated with generation and transmission, not included in distribution costs, and with a number of costs such as pensions and benefits, that are generally outside of the Company's control.

Q. Please discuss the differences between the Grid and the KeySpan allocation methodologies.

A. As noted earlier, the direct charging of costs and the allocation of costs for which some type of cost causation has been identified do not differ significantly. However, costs that are not so identified and which therefore are allocated on a general allocator have been treated differently. KeySpan service companies use a three-point allocator, while the National Grid Service Company uses only O&M expense for its general allocator. PA Consulting Group recommended that a three-factor allocator be adopted which weights equally Gross Margin, Net Plant, and O&M Expenses. (Laflamme Direct p. 17) The specific definition of Gross Margin that has been chosen subtracts from total revenues all purchased power and gas costs, New York state utility assessments, and also stranded costs for those utilities that are charging for stranded costs. This makes the measure more comparable across states.

Q. Do you think it is reasonable to consolidate the allocation methodologies?

A. Yes. It does not make sense to allocate similar type of general costs in a different manner because they currently originate in different service companies. When the service companies are consolidated, the same methodology would be applied to similar costs. By reallocating now, the resulting allocation should be the same as or similar to the allocation after consolidation.

Q. What appears to be the major reason that affiliate costs have shifted from Narragansett Electric to Narragansett Gas?

A. The Gas Company has a higher share of Gross Margin and of Net Plant than it does of O&M expense. I expect that some of this is because the gas utility can make some margin through its incentive associated withthe release of pipeline capacity and the gas purchasing incentives, while the restructured electric distribution utility does not have this source of margin.

Q. Do you think that the three-point allocation that has been adopted is an improvement over the O&M expense allocation that was used by the National Grid service company.

A. Yes. The crucial issue in selecting an allocator is whether it reasonably reflects the need for general costs such as corporate oversight, financial, and accounting costs. It seems to me that there will be a closer relationship between the need for such general costs and all of the activities that give rise to gross margin than to operating and maintenance expense. Some service company costs support the activities that give rise to gross margins, and others are related to plant.

Q. You seem to find the reallocation of service company costs reasonable. Do you have any other comments regarding service company costs and the Rhode Island affiliates?

A. There are a number of challenges resulting from the large amount of Narragansett Gas and Narragansett Electric Companies costs that result from allocations of service company costs. It is significantly more difficult for a state commission to scrutinize such costs as thoroughly as they can locally incurred costs. A large portion of National Grid service company employees are located in the southern New York/Long Island region. The wage levels in these areas are higher than those in New England. I would expect that real estate related costs are also higher in these locations.

Q. What appears to be the impact of the National Grid organization on Narragansett Electric and Gas costs?

A. It appears that many decisions regarding utility operations and management are driven by an overview by National Grid of all of its affiliates, particularly of all of its electric distribution companies. Not all perceived system-wide needs may be justified by Narragansett Electric and Gas needs.

Q. Have the analyses by EY and PA provided evidence that the level of service company costs result in minimizing the cost of providing these services?

A. No they do not. They have determined that services billed are valid and charged appropriately, but they have not provided evidence that these services are competitively priced or are the least cost means of providing such services.

Q. Has the Company presented any evidence that what it is paying its service companies for the services provided is reasonable, compared to what it would pay if it performed these services directly or if it purchased them from competitive vendors?

A. No, it has not. It has not market tested these services by issuing RFPs to determine if they could be acquired at less cost elsewhere. (DIV 11-24) It has not presented any benchmark studies that compare its costs to other utilities.

Q. How does the Company explain why it does not utilize RFPs to search for lowest cost providers?

A. The response to DIV 11-24 states that the functions performed by the service companies require in depth knowledge of each company. Further it notes that all services procured from affiliates are provided at cost, without the markup that they could incur if the services were provided by other entities. These Service Company costs, however, do include allocations of overhead, pensions and benefits, working capital, depreciation, and a return to the Service Company. These are the costs that an outside supplier could recover through a "markup."

The Company testifies that it benchmarks its labor costs against other utilities. However, labor compensation in the lower New York and Long Island area is higher than average New England costs by from 6 to 8%. The location of 36% of service company employees in New England mitigates against this problem. Upstate New York labor costs are lower than New England costs.

Q. Do you agree that the Company could not outsource most activities performed by the service companies?

A. No. I agree that a number of functions could not be outsourced, but I believe that many services, such as billing and engineering services, could be performed by third party vendors. Moreover the claim that services require in depth knowledge of the operating company would appear to be in conflict with the fact that so many Rhode Island activities are performed by employees that are not located in Rhode Island and whose knowledge of the Rhode Island utilities must be somewhat limited.

Q. If all Service Company services which are charged to the Company are computed on the basis of a formula referring to service company costs or on the basis of a direct assignment, does this demonstrate that affiliate costs are no greater than the market value of the service?

A. No, it does not. The formula underlying these costs include a return and overhead that are similar to what any competitive company would charge. Service company costs could be higher than market based costs for any of the following reasons:

- The service company was located in a high labor cost area;
- Competitive suppliers would sometimes accept a lower profit margin than the service company builds into its costs;

- The allocation of costs to the Company raised its share of costs to a higher level than if it selected and contracted for the service based on its own specific needs;
- The service company was not the most efficient provider; and
- Service company facilities were located in a high price real estate area.

Q. Are you recommending any disallowance of service company costs in this proceeding?

A. No. I recommend, however, that in its next rate filing the Company be required to demonstrate that services provided by the service companies are least cost. Appropriate data would include comparison to other utilities and the results of RFPs except where there is specific evidence that the service could not be provided by outside entities.

I also recommend that in future proceedings National Grid provide evidence of the economies of scale and efficiencies that it claims result from its centralized operations.

Q. Does this conclude your testimony?

A. Yes.

Lee Smith

Senior Economist, Managing Consultant

Lee Smith is a Managing Consultant and Senior Economist at La Capra Associates. Ms. Smith has over twenty-seven years experience in utility economics and regulation. Her work has encompassed all aspects of utility pricing, cost analysis, forecasting, and both demand-side and supply planning in electric, gas, and water utility cases. Ms. Smith has analyzed issues of electric and gas rate design, including rate unbundling and appropriateness of utility costs in 20 different states for a multitude of utilities and other entities. She is an experienced witness, have testified across the country and at FERC. She participated in development of the New England ISO, and has advised a number of clients on various aspects of electric restructuring. As a consultant, her clients have included gas and electric utilities, regulatory commissions and other public bodies. Prior to joining La Capra Associates, Ms. Smith was employed as the Director of Rates and Research at the Department of Public Utilities.

PROFESSIONAL EXPERIENCE

Cost Allocation and Rate Design

- Assisted Utah Division of Public Utilities in analyzing cost allocation and rate design for both electric and gas utilities.
- Testified for Nevada Bureau of Consumer Protection on electric cost allocation on basis of marginal cost study and also on rate design.
- Testified on behalf of Massachusetts Office of the Attorney General on electric and gas cost allocation and rate design in multiple cases.
- Developed cost allocation and rate designs for many electric and gas cooperative and municipal utilities.
- Testified on behalf of the Georgia Public Service Commission staff on allocation of distribution and generation costs by the Savannah Electric Company.

Regulatory Policy

- Testified on behalf of Nova Scotia Small Business Advocate on cost allocation and on policy regarding Revenue Cost ratios in Nova Scotia Power rate case.
- Assisted the Massachusetts Attorney General in reviewing policy for gas utility treatment of margins from capacity release.
- Advised Pennsylvania Office of the Public Advocate staff in restructuring proceedings; presented testimony on cost functionalization and rate unbundling in eight cases; testified against GPU’s attempt to change Restructuring Settlement.

- Testified on behalf of the Ohio Consumers' Counsel on American Electric Power proposed response to legislated Energy Security Plan

- Testified on behalf of Massachusetts Attorney General on preapproval of investments in solar installations and resulting rate impacts.

- Testified on behalf of the Wisconsin Citizens Utility Board in a number of cases on cost allocation, power costs, and ratemaking methodology.

- Testified on behalf of the Arizona Corporation Commission Staff that a utility's management of its power costs had not been prudent; also assisted in drafting Codes of Conduct for Electric Affiliates.

- Assisted Massachusetts Department of Energy Resources in drafting energy legislation and negotiating settlements with utilities.

Alternative Rates

- Testified on behalf of the Massachusetts Attorney General regarding Performance Based Ratemaking for gas utilities.

- Assisted Green Mountain Power (Vermont) in developing an Alternative Ratemaking Mechanism.

- Testified for Oklahoma Attorney General on proposed rate rider that would shift risk from utility to customers.

- Assisted Pennsylvania Office of the Public Advocate in case regarding PPL's proposed alternative TOU rates for default service customers

- Authored a white paper for the Governor's Office of Energy Policy of the State of Kentucky on whether and how changes in rate designs and ratemaking methodology could contribute to encouraging more efficient use of electric energy.

- Assisted Connecticut Municipal Electric Cooperative in analyzing potential for time of use rates for its five member utilities.

Merger Analysis

- Testified on behalf of the Massachusetts Attorney General on estimated merger savings and appropriate rate treatment of savings
- Assisted Pennsylvania Office of the Public Advocate in addressing electric utility mergers and merger savings.
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RTO Policy and Regulatory Policy Issues

- Analyzed net revenue impacts of Entergy joining MISO on behalf of Arkansas Public Service Commission staff.

- Testified for Connecticut Office of Consumer Counsel on cases regarding treatment of New England ISO ancillary service costs.

- Testified for the Pennsylvania Office of the Public Advocate staff and the Maryland Office of the People's Counsel on FERC SMD issues.

- Represented the Massachusetts Department of Energy Resources at NEPOOL committees engaged in developing the New England Independent System Operator, and an Open Access Transmission Tariff for New England.

- Assisted Washington Office of the Attorney General Assisted Public Counsel addressing power cost collection mechanisms of Puget Sound Energy and Pacificorp.

Other

- Experienced witness, having presented testimony in over 20 states in more than 50 proceedings

- Assisted in developing cost allocation methodologies in several states.

- Testified on gas hedging practices for City of Houston

- Assisted a Wisconsin electric utility in developing supply hedging plan.

- Testified for Arkansas Commission Staff on various issues, including sale of baseload generating capacity after loss of a wholesale customer.

EMPLOYMENT HISTORY

La Capra Associates — Boston, MA
Managing Consultant — *1984 - present*

Department of Public Utilities — Boston, Ma
Director of Rates and Research — *1982 - 1984*

EDUCATION

Tufts University — Medford, MA
Ph.D. in Economics, all but dissertation — *1966 - 1969*
Economics Department Fellowship

Boston College — Boston, MA
Study of Statistics — *1966*

Brown University — Providence, RI
B.A. with Honors, International Relations and Economics — *1965*

Prize in International Relations

PROFESSIONAL

Bunting Institute Fellowship *1970 - 1971*

PUBLICATIONS AND PRESENTATIONS

Non-price Issues in Gas Supply Planning, NATIONAL REGULATORY RESEARCH INSTITUTE, Biennial Regulatory Research Conference, 1994

The Economic Impact of Hurricane Agnes on the Chesapeake Bay in Maryland, JOHN HOPKINS PRESS

"*Development and Implementation of Restructuring in New England*", Institute of Public Utilities at Michigan State University Williamsburg Conference, December 1995

"*Planning for Gas and Electric Reliability*", NARUC Biennial Regulatory Information Conference, Vol. II, 1994

"Consumer Advocate Reponses to Generation Rate Requests", NASUCA Midyear Conference, 2006

"*Gas Distribution Company Rate Design: What is in the Customer's Best Interest"* NASUCA Midyear Conference, 2010