

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS
PUBLIC UTILITIES COMMISSION

IN RE: NARRAGANSETT ELECTRIC COMPANY :
STANDARD OFFER SERVICE RATE : DOCKET NO. 3508

REPORT AND ORDER

I. BACKGROUND

The Utility Restructuring Act of 1996 (“URA”) requires each electric distribution company to arrange with wholesale power suppliers for a standard power supply offer to sell electricity to all customers at a stipulated rate. Pursuant to the URA, Narragansett Electric Company (“Narragansett”) entered into wholesale Standard Offer supply contracts with the following prices:

<u>Calendar Year</u>	<u>Price per kWh</u>
2003	4.7 cents ¹
2004	5.1 cents
2005	5.5 cents
2006	5.9 cents
2007	6.3 cents
2008	6.7 cents
2009	7.1 cents

The wholesale Standard Offer supply contracts also provide for increases in the price per kilowatt-hour (“kWh”) of wholesale power supplied to Narragansett in the event fuel prices increase above certain levels. To the extent that the total cost of the wholesale power supply to Narragansett, including fuel charges, exceeds retail Standard Offer

¹ Pursuant to Commission Order No. 16916 (issued February 15, 2002), approving an averaged three-year rate from 2002 through 2004, the 2003 SOS rate is 4.662 cents per kWh.

Service (“SOS”) revenues, the under-collection is recoverable from Narragansett’s customers through the annual reconciliation provisions of the Narragansett’s Standard Offer Adjustment Provision. Likewise, any over-collection is credited back to Narragansett’s customers in the same manner.

II. NARRAGANSETT

On April 14, 2003, Narragansett filed with the Rhode Island Public Utilities Commission (“Commission”) a request to increase the retail SOS rate from the present rate of 4.662 cents per kWh to 5.6 cents per kWh for consumption on and after June 1, 2003. The result for a typical residential customer using 500 kWh of service would be a 9.0% increase equal to \$4.89. Therefore, the average monthly residential bill would increase from \$54.61 to 59.50.² In support of the proposed rate increases, Narragansett presented the pre-filed testimony of Jeanne A. Lloyd, Principal Financial Analyst from National Grid USA Service Company, and Michael J. Hager, Vice President, Energy Supply – New England for National Grid USA Service Company.

In his pre-filed testimony, Michael Hager explained that the fuel index adjustments contained in Narragansett’s Standard Offer supply contracts are based on Narragansett’s forecasted costs under the fuel index adjustment provisions using the future gas and crude oil prices reported in the Wall Street Journal. For his analysis in the instant filing, Mr. Hager used the prices reported in the Wall Street Journal on March 26-28, 2003. His analysis shows that Narragansett will pay an arithmetic average fuel index adjustment payment of 1.6408 cents per kWh and 1.9054 cents per kWh for the EUA

² Narragansett Ex. 1A, Pre-filed testimony of Jeanne A. Lloyd, pp. 2-3,14-15. In June 2001, because of high fuel costs, the SOS rate was 6.3 cents per kWh. The average residential bill was \$66.40 per month.

Zone load for the period June 2003 through December 2003.³ This equates to a total SOS cost under the contracts of 6.3408 cents per kWh and 6.6054 cents per kWh, respectively.⁴

In comparing the Rhode Island long term SOS contracts with the fuel index to market prices, Mr. Hager noted that in February 2003, Massachusetts Electric procured a portion of its SOS requirements for the period May 2003 through April 2004 at an arithmetic average rate of 6.787 cents per kWh. In March 2003, Massachusetts Electric also procured Default Service for the period May 2003 through October 2003 at an average of 7.365 cents per kWh for residential customers, 7.909 cents per kWh for small commercial customers and from a low of 7.375 cents per kWh to a high of 8.622 cents per kWh for industrial customers.⁵

In her testimony, Ms. Lloyd indicated that the current averaged SOS rate of 4.662, as approved in Docket No. 3402, does not include any fuel index adjustment costs.⁶ This rate was designed to accrue an over-collection in the SOS account in 2002, when the SOS base rate was 4.2 cents per kWh and which would be sustained at the end of 2003 when the SOS base rate is 4.7 cents per kWh in order to offset an under-collection in 2004 when the SOS base rate is 5.1 cents per kWh. In addition, in Docket No. 3402, the Commission allowed Narragansett to retain a \$20 million payment from a supplier in order to offset any unexpected fuel charges with the hope that the 4.662 cent rate would not be impacted by these charges. At that time, it appeared the market was stabilizing and it would be feasible to provide ratepayers with a stable three-year rate after a year

³ Narragansett Ex. 1B, Prefiled testimony of Michael Hager, pp. 5-6.

⁴ Id. at 6.

⁵ Id. at 7-8.

⁶ Narragansett Ex. 1A, p. 4.

and a half of regularly fluctuating rates. Unfortunately, the wholesale fuel market has not remained as stable as hoped. Therefore, in Docket No. 3479, the Commission allowed Narragansett to offset fuel index prices with the supplier payment that had grown to \$21,091,367 with the hope that this would be enough to allow ratepayers continuation of the 4.662 SOS rate through the end of 2003. However, current projections show that if Narragansett does not request an increase in the SOS rate from its current level, the Company will experience an under-collection in the SOS account in the amount of \$29,775,335 million at the end of December 2003. This amount includes offsets from the supplier payment and the remaining over-collection from 2002.

Ms. Lloyd explained that if Narragansett does not apply the over-collection from 2002 against the increased costs for providing SOS, the rate would have to be increased to 6.5 cents per kWh for the remainder of 2003, with a probable decrease in January 2004. Additionally, if the Company were to propose a levelized rate through the end of December 2004, the SOS would be 5.746 cents per kWh. However, due to the volatility in the wholesale energy market, Narragansett is not proposing this approach. Finally, according to Ms. Lloyd, if the Commission approves the request to set the SOS rate at 5.6 cents per kWh, the estimated 2004 SOS rate is estimated to be 5.8 cents per kWh.

III. COMMISSION DATA REQUESTS

Although the Commission has had to address the issue of fuel index adjustment factors in the past, several data requests were issued to Narragansett in an attempt to address alternatives and policy choices.

Response to Data Request 1-4, Attachment 2, provided updated projections through the end of the year. In its initial filing, Narragansett used oil and gas prices as

reported on March 26-28, 2003. In its Data Response, Narragansett used April 25, 28-29, 2003 prices. In only a month's time, the market changed so drastically, that the proposed rate for the rest of the year dropped from 5.6 cents per kWh to 5.4 cents per kWh.

Responses to Data Request 1-6 showed comparisons of the 2003 energy market to the 2001 energy market. Response to Data Request 1-7 showed the comparison of oil and gas price projections between March 28, 2003 and May 7, 2003. While oil prices dropped somewhat, natural gas prices increased. The main reason the proposed increase dropped is because the fuel index adjustment provision is based on a formula that takes both prices into account.

Narragansett's response to Data Request 1-5(b) provided the Commission with what appeared to be a viable alternative to a seven-month rate. This alternative required approval of a small increase for the three-month period June through August from 4.662 cents per kWh to 4.775 cents per kWh with another moderate increase for the period September through December to 5.613 cents per kWh, very close to the amount requested in Narragansett's initial filing.

IV. DIVISION

In response, on May 21, 2003, the Division of Public Utilities and Carriers ("Division") submitted the pre-filed testimony of its consultant, Dr. John Stutz.⁷ Dr. Stutz testified that based on Narragansett's responses to Commission data requests, the Division supports approving a SOS rate of 5.4 cents per kWh for usage for the remainder of 2003. Dr. Stutz noted that the projected rate for 2004 was also reduced to 5.6 cents per kWh.

⁷ Division Exhibit 1, Pre-Filed Testimony of Dr. Stutz.

Dr. Stutz also explained that the challenge is to set rates that manage the impact of fuel prices to provide slow and stable growth. The current SOS rate has provided ratepayers with stability for seventeen months. However, the high fuel prices necessitate an increase. Therefore, Dr. Stutz indicated that setting the SOS rate at 5.4 cents per kWh for the remainder of the year will provide customers with a stable price for the remainder of 2003. Furthermore, he opined that based on projections, this rate can be expected to cover the anticipated costs for the remainder of 2003.

V. HEARING

A public hearing was held at the Commission's offices, 89 Jefferson Boulevard, Warwick, Rhode Island, on May 28, 2003. The following appearances were entered:

FOR NARRAGANSETT:	Terry L. Schwennesen, Esq.
FOR THE NAVY:	Audrey VanDyke, Esq.
FOR DIVISON:	Paul J. Roberti, Esq. Assistant Attorney General
FOR COMMISSION:	Cynthia G. Wilson, Esq. Senior Legal Counsel

Mr. Henry Shelton appeared on behalf of the George Wiley Center and the Campaign to Eliminate Childhood Poverty to request, through public comment, that the Commission not approve the requested increase. At the very least, he requested that those Narragansett customers who fall within the protected class status of the Commission Rules and Regulations Regarding the Termination of Gas, Electric and Water Service be excluded from any increase.⁸

At the hearing, Mr. Hager and Ms. Lloyd testified on behalf of Narragansett in support of the requested rate change as filed. Ms. Lloyd made corrections to her original

schedules JAL-2 and JAL-5, resulting in a requested SOS increase from 4.662 cents per kWh to 5.5 cents per kWh, rather than 5.6 cents per kWh. This would increase the total bill for a typical residential customer using 500kWh per month from \$54.61 to \$58.98 per kWh, or 8%. Ms. Lloyd also provided the Commission with updated fuel prices as reported in the Wall Street Journal on May 21, 22 and 23.

Mr. Hager also provided the Commission with an updated comparison of oil and natural gas prices between March 28, 2003 and May 23, 2003. Unlike the comparison between March 28, 2003 and May 7, 2003 which had shown single digit percentage increases in natural gas prices and generally decreases in oil prices through 2004, the May 7, 2003 data showed mostly double digit percentage increases in natural gas prices and single digit increases in oil prices. Therefore, according to Mr. Hager, the fuel “market has shown significantly more volatility in the last several months...than in past periods.”⁹

Mr. Hager explained that the SOS was designed to be a transitional service between a fully regulated industry and a competitive marketplace. It was structured with a fixed price component designed to escalate each year through 2009. However, in order to provide a level of protection to wholesale suppliers from extraordinary increases in gas and oil prices, the contracts contain a formula related to oil and natural gas prices which, if exceeded, trigger a fuel adjustment provision.¹⁰ In 2003, the trigger price for that

⁸ Tr. 5/28/03, pp. 10-24.

⁹ *Id.* at 46.

¹⁰ Mr. Hager testified that “it is a fact that the tariffs at the time of the EUA merger only included fuel adjustment trigger amounts and payments through 2004. It’s Narragansett’s opinion that those suppliers are only entitled to fuel adjustment payments through 2004 and that they cease to those entitlements on January 1, 2005, whereas in the Narragansett zone contracts, those do include trigger payments through 2009. Mr. Hager stated that he is not aware of any supplier who disputes Narragansett’s position. As of April 2003, approximately 73% of the SOS load was served under former Narragansett zone contracts and the remaining 27% under former EUA zone contracts. Mr. Hager testified that it was his hope that by

provision is \$7.01 per million Btu. If the average price on a rolling basis is below that level, the supplier is not entitled to additional fuel related payments. However, if the prices exceed that trigger point, the supplier is entitled to a proportional increase in the SOS price. Therefore, Mr. Hager agreed that it is fair to say because the fuel index trigger point has been met or exceeded that the ratepayers are faced with a time of extraordinarily high oil and gas prices.¹¹

Specifically, Mr. Hager stated that natural gas prices have gone through a huge increase sometime around March 2003, when prices were over \$9 per million Btu, similar to the prices seen in January 2001. Although the prices have dropped to the \$5 range, there is still a long way to go to get back to the expected prices for gas. Similarly, in March 2003, oil prices hit their highest level since 1996.¹² However, even with the addition of the fuel index adjustment provision, 5.5 cents per kWh is still below the market rates in New England, where a default service procurement in Massachusetts in March 2003 resulted in a residential retail rate of 7.4 cents per kWh. Furthermore, Massachusetts' SOS rate is currently 5.62 cents per kWh.¹³

Despite the market volatility, Mr. Hager believed that it is reasonable to allow Narragansett to project a seven-month rate. Addressing the Commission's policy question of a two-step rate over seven months versus a single-step seven-month rate, Ms. Lloyd indicated that either choice is dependent on the market with regard to accuracy.

2005, the fuel trigger point would be so high that even if oil and gas prices are extraordinarily high, no fuel adjustment payments will be due at all. Tr. 5/28/03, pp. 88-89.

¹¹ Id. at 38-42.

¹² Id. at 42-44.

¹³ Id. at 47-48. Massachusetts' SOS is slightly different from Rhode Island's. The only residential customers on Massachusetts' SOS rate are those who were put on SOS in 1997. Any customer who began taking electric service after March 1, 1998 are considered default service customers. In Rhode Island, all residential customers except for those who went to market and returned to last resort service are eligible for

Using the updated fuel prices, Ms. Lloyd provided the Commission with a chart showing three possible two-step rates, the first increase for effect June 1, 2003 and the second for effect September 1, 2003. Because of the increased fuel prices between May 7, 2003 and May 28, 2003, the only alternative which allowed for a September rate below 5.6 cents per kWh (5.577 cents per kWh) required a rate increase to 5.4 cents per kWh. Under each alternative provided, ratepayers would be paying more than the proposed 5.5 cents per kWh for the last four months of 2003.¹⁴

In order to address the concern that unusual volatility in the fuel markets complicate the task of accurately forecasting fuel adjustment payments for an extended period of time, Ms. Lloyd testified that the Company would be monitoring the market and filing reconciliations on a monthly basis based on the most recent fuel price estimates for that month.¹⁵ Ms. Lloyd indicated that while the Company had not determined a consistent benchmark forecasted over- or under-collection to trigger a filing to the Commission, she suggested \$10 million.¹⁶ Absent the requested increase, Narragansett would accrue an under-collection of approximately \$30 million by December 31, 2003, which the Company would account for in its annual reconciliation filing in December.¹⁷ However, based on current projections, Narragansett estimates a slight over-collection at

SOS. Additionally, all residential customers in Rhode Island are entitled to pay the SOS rate, even if they are on last resort service.

¹⁴ Id. at 34-36, Narr. Ex. 3.

¹⁵ Recognizing that ratepayers would prefer never to have their rates raised, the Commission and the witnesses also addressed the perennial question of what customers prefer, larger increases following longer periods of rate stability or smaller increases more frequently. Additionally, the Commission and the witnesses began to discuss the question of whether a monthly rate change would be in the ratepayers' best interests as opposed to a seven-month rate which may not be entirely accurate. Tr. 5/28/03, pp. 58-68.

¹⁶ Tr. 5/28/03, pp. 54-57.

¹⁷ Id. at 56.

the end of December 2003, as a rate of 5.47 cents per kWh would “put you at dead even.”¹⁸

The Division presented Dr. John Stutz, who testified that, based on the calculations provided by Narragansett at the commencement of the hearing, he recommended the Commission approve a rate of 5.5 cents per kWh. In support of his recommendation, Dr. Stutz indicated that he believed the Commission should attempt to provide some degree of rate stability as the impact of very volatile fuel prices slows. He further testified that the Commission should allow the price to continue through the remainder of the year, even if there are modest fluctuations in the fuel prices. It was his position that market volatility can be managed over a period of years rather than months and therefore, the Commission should not be as concerned as it has been in the past with setting rates to reach a zero over- or under-collection at the end of each reconciliation period.¹⁹

COMMISSION FINDINGS

At its open meeting on May 30, 2003, the Commission accepted Narragansett’s revised filing to set the SOS rate at 5.5 cents per kWh effective for consumption on and after June 1, 2003.

The Commission has a policy of encouraging stable rates over a reasonable period of time. This is the first SOS increase since April 1, 2001, when the SOS rate was 6.3 cents per kWh.²⁰ The SOS rate has been the same since January 1, 2002, when the Commission approved a rate of 4.662 cents per kWh, designed to be in effect for three

¹⁸ Id. at 121.

¹⁹ Id. at 99-106, 108-112.

²⁰ In April 2001, because of high fuel costs, the SOS rate was 6.3 cents per kWh. The average residential bill was \$66.40 per month.

years, absent a spike in the oil and natural gas markets. Even with this increase, the average residential customer is still paying a lower total bill for electricity than he or she was in December 1997.²¹ Furthermore, the Commission notes that even with the increase in SOS, a comparison of the procurement prices for electric service in Massachusetts indicates that the Rhode Island SOS rate is still below market.²²

The necessity of this increase is due to the increases in the cost of wholesale oil and natural gas. As part of Narragansett's SOS agreements with suppliers, when the fuel charges increase above a certain level, Narragansett must pay the suppliers an additional amount in addition to the base contract price for SOS, which, for 2003 is 4.7 cents per kWh. The purpose of this is to provide the supplier with protection against the impact of extraordinarily high fuel prices. The charges under the fuel adjustment provision also provide somewhat of a market signal to ratepayers. A market is inherently unstable and, arguably, a truly competitive market should track that instability. Unfortunately, at this point in time, choice in the electricity market does not exist for residential customers. Therefore, in each request for an increase relative to wholesale fuel prices, the Commission attempts to balance the need for the increase against a desire for stability.

²¹ The Commission notes that in December 1997, the average residential customer's monthly electric bill was \$61.92.

²² While some may criticize the fact that the Rhode Island SOS rate is below market as a barrier to competition, the Commission reiterates its position that if competition is to develop, it should develop under the market conditions that exist in the state and produce lower rates without artificial rate increases simply to create competition. The premise is that competition will produce lower electric rates. The method that has been advocated repeatedly before this commission is, in essence, if the Commission would just raise retail rates above an arbitrary level (usually at least a penny above the SOS contract price), competitors could enter the market and offer rates lower than the artificially high rate set by the Commission. As this Commission has stated repeatedly, "...it must be emphasized that the creation of *competition is beneficial only if it produces savings for ratepayers*. The payment of higher prices to create a competitive market, just for the sake of having a competitive market, is economic logic turned upside down. The Commission rejects it." Order No. 15520 (issued July 10, 1998), Order No. 15521 (issued July 10, 1998) (emphasis added), Order No. 16916 (issued February 15, 2002).

In Docket No. 3402, one aspect of the testimony was undisputed – people want certainty.²³ The Commission has previously noted that its “...longstanding policy is to promote rate stability and to avoid unnecessary fluctuations in rates. Minimizing the rate changes in this fashion should promote competition by providing competitors with a relatively fixed price against which to compete...”²⁴ Furthermore, a stable rate provides both marketers and ratepayers a benchmark by which to compare competitive rates.²⁵ In this docket, Ms. Lloyd testified that it was her “understanding [] that the call volume increases with every rate increase or rate change.”²⁶

However, at the hearing, the Commission initiated a discussion regarding whether the Commission should change its policy of promoting rate stability and therefore, whether the SOS rate should be set for a period of time or should be a variable rate that might change each month. Because it is possible that continuation of this discussion could lead to a policy change for the Commission, the Commission directs legal counsel to set up a conference with the parties to discuss the best procedure for continuing this inquiry.

The Commission has also established a policy of not allowing a large under-collection to accrue in the SOS account because Narragansett is allowed to earn interest on the under-collection and because an under-collection requires a larger increase in the future which could lead to rate shock. During 2000-2001, in order to avoid accrual of

²³ Tr. 12/10/01, pp. 70 (Mr. Stoddard, the General Assembly’s witness who was arguing against the three-year levelized rate proposal stated, “I think what people dislike most is uncertainty.”), 113 (Dr. Stutz stated that he agreed with Mr. Stoddard’s statement), 118 (Mr. Scialabba stated that he agreed that “customers like stable rates in Rhode Island), 171 (Ms. Lloyd adopted and reiterated her statement that customers have expressed “concern about the ups and downs that occur[ed] [with the rates].”)

²⁴ Order No. 15735 (issued December 31, 1998).

²⁵ The Commission has previously received testimony that stable prices over a longer period of time is preferred by competitive suppliers and assists customers in budgeting their energy costs. Order No. 16635 (issued June 13, 2001).

significant under-collections due to rising oil and natural gas prices, the Commission approved five rate increases over the course of ten months. The base SOS rate was 3.8 cents per kWh in 2000 and 4.1 cents per kWh in 2001.²⁷ If the Commission were to deny a rate increase until Narragansett's annual reconciliation filing, Narragansett is projecting an under collection of slightly less than \$30 million as of December 31, 2003. This under-collection includes offsets from an over collection of approximately \$35 million from December 31, 2002.

This current rate is designed to collect Narragansett's costs of providing SOS to customers through the end of 2003 with no significant over or under collection. However, in light of the volatility in the wholesale oil and natural gas markets, the Commission finds that it is appropriate to allow the accrual of a reasonable level of over- or under-collection as of December 31, 2003, with the understanding that the amount would either be collected or credited over the course of 2004. In June 2000, the Commission set a rate that would allow for a \$16.2 million under-collection. Recovery

²⁶ Tr. 5/28/03, p. 75.

²⁷ The following shows the history of SOS increases and decreases since January 2000. Although meant to be a relatively stabilized transition rate between a fully regulated industry and a competitive market, the SOS rate is impacted by the competitive wholesale fuel market. The list shows how the wholesale oil and natural gas prices affect the standard offer service rate. During periods of unusual price increases and volatility, the prices reflect that aspect of the market. During periods of relative market stability, retail prices reflect that aspect of the market.

January 2000	3.8 cents per kWh
July 1, 2000	4.1 cents per kWh (designed to be in effect through 2000 and to allow a small under-collection by December 31, 2000).
September 1, 2000	4.5 cents per kWh (under-collection growing so rapidly, PUC required Narragansett to file for an increase for effect 10/1 in order to eliminate the under-collection by 12/31/00)
October 1, 2000	5.401 cents per kWh (eliminate under-collection)
January 1, 2001	5.905 cents per kWh (designed to be in effect through 2001)
April 1, 2001	6.3 cents per kWh (designed to be in effect through 2001)
October 1, 2001	5.5 cents per kWh (designed to have an over-collection of \$1.6 million).
January 1, 2002	4.662 cents per kWh (designed to over-collect for purposes of hopefully providing a three-year rate)

of this amount over 2004 would add approximately .24 cents to the SOS rate in 2004. Therefore, the Commission allows Narragansett to accrue up to \$16 million of over or under collection in the SOS account as of December 31, 2003. If Narragansett's projections prior to its annual reconciliation filing show that the accrual of over- or under-collection will be more than \$16 million, Narragansett shall apply for a rate adjustment for effect prior to its annual reconciliation filing.

Accordingly, it is hereby

(17495) ORDERED:

1. Narragansett Electric Company's proposed retail Standard Offer Service Rate of 5.5 cents per kWh is approved to become effective for service on and after June 1, 2003.
2. Narragansett Electric shall file for a SOS rate adjustment if monthly projections indicate that the SOS account will accrue an over- or under-collection in excess of \$16 million as of December 31, 2003.

January 1, 2003

No change – utilize the \$20 million payment for fuel index adjustment provision and get through the end of 2003

3. Narragansett Electric Company shall comply with all other findings and instructions as contained in this Report and Order.

EFFECTIVE AT WARWICK, RHODE ISLAND PURSUANT TO A BENCH
DECISION ON MAY 30, 2003. WRITTEN ORDER ISSUED JUNE 20, 2003.

PUBLIC UTILITIES COMMISISON

Elia Germani, Chairman

Kate F. Racine, Commissioner

Robert B. Holbrook, Commissioner