STATE OF CONNECTICUT

BEFORE THE DEPARTMENT OF PUBLIC UTILITY CONTROL

In the Matter of the Application of	**)**	
the Connecticut Natural Gas	**)**	**Docket No. 99-09-03**
Corporation for a Rate Increase	**)**	
(Phase II)	**)**	

DIRECT TESTIMONY OF

PAUL CHERNICK

ON BEHALF OF

THE OFFICE OF CONSUMER COUNSEL

Resource Insight, Inc.

SEPTEMBER 25, 2000

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I. Identification and Qualifications

Q: State your name, occupation and business address.

A: I am Paul L. Chernick. I am President of Resource Insight, Inc., 347 Broadway, Cambridge, Massachusetts.

Q: Summarize your professional education and experience.

A: I received an SB degree from the Massachusetts Institute of Technology in June, 1974, from the Civil Engineering Department, and an SM degree from the Massachusetts Institute of Technology in February, 1978, in technology and policy. I have been elected to membership in the civil engineering honorary society Chi Epsilon, and the engineering honor society Tau Beta Pi, and to associate membership in the research honorary society Sigma Xi.

I was a utility analyst for the Massachusetts Attorney General for more than three years, and was involved in numerous aspects of utility rate design, costing, load forecasting, and the evaluation of power supply options. Since 1981, I have been a consultant in utility regulation and planning, first as a research associate at Analysis and Inference, after 1986 as president of PLC, Inc., and in my current position at Resource Insight. In these capacities, I have advised a variety of clients on utility matters. My work has considered, among other things, the cost-effectiveness of prospective new generation plants and transmission lines; retrospective review of generation planning decisions; ratemaking for plant under construction; ratemaking for excess and/or uneconomical plant entering service; conservation program design; cost recovery for utility efficiency programs; the valuation of environmental externalities from energy production and use; allocation of costs of service between rate classes and jurisdictions; design of retail and wholesale rates;

and performance-based ratemaking (PBR). My resume is appended to this testimony as Exhibit PLC-1.

Q: Have you testified previously in utility proceedings?

A: Yes. I have testified approximately one hundred and sixty times on utility issues before various regulatory, legislative, and judicial bodies, including the Arizona Commerce Commission, Connecticut Department of Public Utility Control, District of Columbia Public Service Commission, Florida Public Service Commission, Maryland Public Service Commission, Massachusetts Department of Public Utilities, Massachusetts Energy Facilities Siting Council, Michigan Public Service Commission, Minnesota Public Utilities Commission, Mississippi Public Service Commission, New Mexico Public Service Commission, New Orleans City Council, New York Public Service Commission, North Carolina Utilities Commission, Public Utilities Commission of Ohio, Pennsylvania Public Utilities Commission, Rhode Island Public Utilities Commission, South Carolina Public Service Commission, Texas Public Utilities Commission, Utah Public Service Commission, Vermont Public Service Board, Washington Utilities and Transportation Commission, West Virginia Public Service Commission, Federal Energy Regulatory Commission, and the Atomic Safety and Licensing Board of the U.S. Nuclear Regulatory Commission. A detailed list of my previous testimony is contained in my resume.

Q: Have you testified previously on issues of utility mergers and corporate restructuring?

A: Yes. I filed testimony in the PacifiCorp–Scottish Power merger proceedings in Utah and Washington State, on the reorganization (formally a merger) of Boston Edison into a newly formed holding company, and on the proposed

merger of Central Maine Power into Energy East Corporation in Docket No. 99-411.

Q: Have you testified previously before this Commission?

A: Yes. I testified in

- Docket No. 83-03-01, a United Illuminating (UI) rate case, on behalf of the Office of Consumer Counsel, on Seabrook costs.
- Docket No. 83-07-15, a Connecticut Light and Power (CL&P) rate case, on behalf of Alloy Foundry, on industrial rate design.
- Docket No. 99-02-05, the CL&P stranded-cost docket.
- Docket No. 99-03-04, the UI stranded-cost docket.
- Docket No. 99-03-35, the UI standard-offer docket.
- Docket No. 99-03-36, the CL&P standard-offer docket.
- Docket No. 99-08-01, investigation into electric capacity and distribution.
- Docket No. 99-09-12, the nuclear-divestiture plan for CL&P and UI.

Q: Are you the author of any publications on utility planning and rate-making issues?

A: Yes. I am the author of a number of publications on rate design, cost allocation, power-plant cost recovery, conservation-program design and cost-benefit analysis, and other ratemaking issues. Several of my recent papers deal with issues in industry restructuring, including integrated resource planning, environmental considerations, and stranded-cost determination. These publications are listed in my resume.

Q: Are any of your publications particularly relevant to the subject matter of the current testimony?

1 A: Yes. I am a co-author of the 1997 NARUC report on performance-based
2 ratemaking entitled "Performance-Based Regulation in a Restructured
3 Electric Industry."[1]

4 **II. Introduction**

5 **Q: On whose behalf are you testifying?**
6 A: I am testifying on behalf of the Connecticut Office of Consumer Counsel
7 (OCC).
8 **Q: What is the purpose of your testimony?**
9 A: I was asked to review the manner and extent to which the Connecticut
10 Natural Gas Corporation (CNG or the Company) has proposed to flow
11 through to ratepayers the savings resulting from its purchase by Energy East.
12 **Q: Please summarize your conclusions.**
13 A: The Company's proposal fails to ensure that ratepayers will benefit from the
14 merger. The Company's Rate-Plan Alternative (RPA), which the Company
15 now refers to as an Incentive Rate Plan (IRP), would award to stockholders
16 an excessive share of cost savings, with no distinction made between savings
17 enabled by the merger and those achievable in the absence of the merger.
18 Most of the acquisition premium is charged to the ratepayer.
19 In addition, since CNG's proposal would reward inferior performance
20 and allow shareholders to retain many efficiency benefits that would

[1]Biewald, Bruce, Tim Woolf, Peter Bradford, Paul Chernick, Susan Geller, and Jerrold Oppenheim. 1997. "Performance-Based Regulation in a Restructured Utility Industry." Washington: NARUC.

normally be passed to ratepayers, any efficiency incentives created by the Company's proposal are unlikely to produce net savings for the ratepayer.

Q: Please summarize your recommendations.

A: The Department should reject the Company's proposal. In addition, the Department should initiate a new rate case proceeding to set baseline rates for CNG as part of the Energy East holding company. The Company's poorly designed rate plan would likely provide a windfall for shareholders and a deadweight loss for ratepayers, compared to continuation of cost-of-service ratemaking.

If the Department wishes to proceed with development of performance-based ratemaking for gas utilities, it should start by initiating a generic proceeding to establish PBR guidelines for all three Connecticut gas companies. PBR plans can be designed in many ways, to achieve many different objectives; before implementing a PBR plan for an individual company, the Department should clarify its objectives and select a PBR framework that serves those objectives. While some aspects of PBR may vary between utilities, other aspects should be set consistently for all three utilities; this requires a generic proceeding. Performance-based ratemaking should be designed to reward management's skill and dedication in improving efficiency and controlling costs, while maintaining quality service. Especially in the case of companies whose costs are expected to decline due to mergers, the Department must be careful to ensure that ratepayers are no worse off with the PBR plan than under traditional ratemaking.

If the Department adopts a rate-cap form of PBR, I recommend that the annual rate adjustment be computed from the actual rate of inflation, net of productivity improvements, with provisions for changes in specific uncon-

1 trollable cost items and sharing of excess earnings. While specific inputs may
2 vary, all gas utilities in the state should be using the same basic formula for
3 the rate plan, including the estimate of industry-wide productivity improve-
4 ments. They should also be basing their performance standards on the same
5 industry-wide definitions and performance, using similar provisions for
6 uncontrollable costs, and incorporating similar provisions for reflecting
7 uncontrollable costs and extraordinary occurrences.

8 **Q: How is the remainder of your testimony organized?**

9 A: The next section describes the Company's proposal for sharing merger bene-
10 fits with ratepayers. Section IV evaluates CNG's earnings-sharing
11 mechanism. Section V reviews CNG's proposed treatment of the acquisition
12 premium. Section VI briefly considers the Company's argument regarding its
13 need for incentives to improve efficiency. Section VII discusses how,
14 following a merger, a PBR plan should be designed to ensure equitable
15 sharing of savings between ratepayer and shareholder and effective
16 incentives for management to reduce costs.

17 III. The Company's Proposed Merger Credit to Ratepayers

18 **Q: How does the Company propose to flow through to ratepayers savings**
19 **from the merger?**

20 A: According to the testimony of Company Witness Dr. Gordon, ratepayers
21 would benefit through (1) a 4-year rate "stay-out," (2) earnings sharing after
22 recovery of a portion of the acquisition premium and (3) direct passthrough
23 of gas cost synergies via the gas purchase adjustment clause (Gordon 8/11/00
24 Supplemental at 4–5).

1 **Q: How is CNG's earnings-sharing mechanism structured?**

2 A: The Company's earnings-sharing proposal has the following components:

3 - Shareholders would retain 100% of the first 100 basis points above the
4 allowed ROE of 10.8%. Above 11.8%, overearnings would be split 50-
5 50 between shareholders and ratepayers.
6 - Earnings would be calculated net of (a) the portion of the acquisition
7 premium explicitly recovered by shareholders[2] and (b) marketing costs
8 lagged one year.
9 - Recovery of the acquisition premium in any given year is limited to the
10 lesser of (a) straight-line amortization [2.5%] of the premium or (b) the
11 "total customer merger benefit," defined as the sum of claimed gas cost
12 savings (which would flow through the gas cost adjustment clause) and
13 ratepayers' 50% share of excess earnings.

14 **Q: In CNG's view, how will its proposed RPA/IRP ensure that customers**
15 **will benefit from the merger?**

16 A: The Company makes the following claims:

17 - The Company's proposal would provide ratepayers with a fair share of
18 the merger benefits and efficiency improvements while protecting them
19 on the downside (Gordon 8/11/00 Supplemental at 3–4, 9–10).
20 - Shareholders would only be able to recover the annual amortization of
21 the acquisition premium as long as CNG is able to achieve synergies
22 (Gordon 11/8/99 Direct at 17).

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[2]The 100 basis point of overearnings between 10.8% and 11.8%, as well the share of overearnings, also can be thought of as paying for the acquisition premium.

- Ratepayers benefit from mergers. Utilities will not pursue mergers if they cannot share the benefits and recover the costs of the merger (Gordon 11/8/99 Direct at 18).
- The proposal would improve the Company's incentive to operate efficiently and achieve merger savings (Gordon 11/8/99 Direct at 2–3; Gordon 8/11/00 Supplemental at 3–4).

My testimony will address each of these contentions in turn.

IV. Benefits to Ratepayers under the Company's Proposed Performance-Based-Ratemaking Plan

Q: Does the Company's proposed rate plan ensure that customers receive a fair share of the merger benefits?

A: No, for the following reasons: First, there is no explicit relationship between rates to customers and merger savings. The Company's proposal provides no guarantee of merger savings to ratepayers. It does not contain any explicit rate reduction for merger savings, any explicit productivity factor for the effects of the merger, or any mechanism to limit recovery of the acquisition premium to a fraction of merger-related savings.

Second, while CNG claims that ratepayers would receive 50% of non-gas savings and 100% of gas savings, ratepayers would actually receive a much smaller share of excess non-gas earnings.

Third, the earnings-sharing mechanism does not distinguish between merger savings and other savings (including efficiency improvements resulting from the rate plan). It therefore may deny ratepayers savings that would have occurred in the absence of the merger, for example, from continuing efficiency improvements flowing from technology for which

1 customers are paying in current and future rates, from normal revenue
2 growth, or from changes in regulatory policy. In traditional cost-of-service
3 ratemaking, those savings would flow through to ratepayers. In a PBR plan
4 structured without consideration of a merger, the stockholders might retain a
5 share of savings, but no savings would be diverted to recovery of the
6 acquisition premium.

7 Fourth, under CNG's proposal, ratepayers' actual share of non-gas
8 savings would depend on the accuracy of the estimate of gas-supply
9 synergies. Under conditions that are not unlikely, any increase in the claimed
10 gas-cost savings would increase shareholder recovery of the acquisition
11 premium and reduces the ratepayers' share of earnings.[3] If gas-cost synergies
12 are overstated, the ratepayer is penalized.

13 Fifth, CNG would inappropriately recover a portion of marketing costs
14 from ratepayers.

15 Finally, the Company has not demonstrated that its rate freeze would
16 produce lower rates than normal cost-of-service ratemaking, with reasonable
17 expectations (or pro forma estimates) for inflation and productivity improve-
18 ments. The rate freeze may represent a windfall for shareholders.

19 **Q: What share of savings would customers actually receive under the**
20 **Company's proposal?**

21 A: Under CNG's formula, the incremental share of earnings or gas cost savings
22 depends upon the earned ROE, the level of gas-supply synergies, and the
23 amount of acquisition premium recovered. For a wide range of operating

[3]This happens any time claimed gas-cost savings are less than the shareable earnings (in excess of 11.8%) and the acquisition premium amortization is not entirely recovered.

1 incomes, the ratepayer would receive substantially less than a 50% share of
2 excess earnings and 100% share of gas supply synergies, as follows:

3 - As long as the earned ROE remains less than 11.8%, the shareholders
4 would receive 100% of any earnings in excess o the allowed 10.8%. The
5 ratepayers would receive 100% of any gas-supply synergies, but none of
6 the excess earnings.
7 - If the earned ROE exceeds 11.8%, until the annual amortization of the
8 acquisition premium is fully recovered, the shareholders would receive
9 the following:
10 - 100% of additional earnings up to the level of the gas cost syner-
11 gies and 73% of the additional earnings in excess of that level.
12 About one-third of the additional earnings would go to the
13 recovery of the acquisition premium, and the remaining two-thirds
14 would be split between shareholder and ratepayer. The ratio is not
15 exactly ⅓ to the ratepayer and ⅔ to the shareholder because the
16 earnings sharing formula compares pre-tax to post-tax values.
17 - 27% of incremental gas-supply synergies. For each additional
18 dollar of gas-cost synergy, the shareholders would retain a dollar
19 of net income. As noted above, shareholders would retain 73¢ of
20 net income over the level of gas synergy, so the net gain to share-
21 holders is 27¢. Ratepayers save $1 on gas costs but lose 27¢ (post-
22 tax) on base rates, or 47¢ (pre-tax), for a net gain of only 53¢.
23 - The ratepayers would receive 50% of the overearnings and 100% of the
24 gas-supply synergies only after the annual amortization of the
25 acquisition premium is fully recovered.

1 **Q: Have you estimated how merger savings would be shared on an average**
2 **basis?**
3 A: Yes. The overall share can be easily calculated for the cases presented in Mr.
4 Rude's illustration. The actual average would vary depending upon the actual
5 level of operating income, gas and non-gas merger and non-merger savings
6 and marketing expenses. Exhibit PLC-2 computes the percentage of "net
7 synergy potential" in Exhibit RER-s1a that received by ratepayers, as
8 indicated by the "total customer benefit" in Exhibit RER-s2a. As shown in
9 that exhibit, ratepayers would receive only about a third of CNG's total
10 claimed merger savings. Ratepayers would receive a smaller share of non-gas
11 synergies, ranging from about 0.5% to 26%.
12 The ratepayer share is so small because a substantial portion of the non-
13 gas merger synergies are consumed in paying shareholder the 100 basis
14 points of extra earning from the 10.8% allowed ROE to the 11.8% ROE
15 threshold and in matching the claimed gas synergies; ratepayers would
16 receive none of those savings.
17 Ratepayers would get an even worse deal under CNG's proposal than
18 these percentages indicate. In Mr. Rude's illustrative cases, some non-
19 merger-related savings are absorbed in reaching the 11.8% sharing threshold.
20 Under the Company's proposal, all these savings, whatever their origin,
21 would be retained by shareholders.
22 **Q: How does the Company propose to measure the savings that are merger-**
23 **related?**
24 A: The Company's account of how it would identify the amount of merger
25 synergies achieved is ambiguous and contradictory. According to the
26 Company's response to OCC-2.36, only earnings in excess of 11.8% will be

considered merger-related. According to the response to GA-288, earnings in excess of 10.8% are reasonably assumed to be merger-related and earnings in excess of 11.8% are certainly merger-related.

Mr. Rude's illustration is consistent with the latter definition, that a substantial portion of the earnings between 10.8% and 11.8% reflect merger synergies.

The Company is asking the Department to approve an earnings-sharing mechanism and acquisition-premium recovery that do not require an estimate of merger synergies, except in the case of the gas-cost savings. Dr. Gordon assures the Department that there is no need to focus

> …narrowly on the amount of merger-related savings that the Company is entitled to recover, which in any event would be difficult to measure because of the difficulties of knowing whether the savings could have been achieved absent the merger…. (Gordon 8/11/00 Supplemental at 4)

Interestingly, where actually identifying merger and non-merger savings might mean smaller earnings, the Company regards the estimation too difficult. In the case of the gas cost savings, which would otherwise flow directly through to ratepayers with none going to the shareholders, estimation is not too difficult for the Company.

Q: Why is the potential for biased estimates of gas supply synergies a real concern?

A: Under it's proposal, CNG would have an incentive to overstate the gas supply synergies, at least until it is sure it will recover the entire acquisition-premium amortization for the year. It is not clear how the Department would determine whether CNG's decisions on gas purchasing, portfolio management and loss control would have been different without the merger.

1 **Q: Has the Company provided any assurance to the Department that it will**
2 **be able to produce reliable estimates of gas supply synergies?**
3 A: No. The Company has not been able to provide a detailed methodology for
4 identifying actual merger-enabled gas cost savings, which would require the
5 Company to produce an analysis of the portfolio, gas costs and losses that
6 would exist in the absence of a merger (OCC-2.24). According to its
7 response to GA-300, the Company does not intend to present any specific
8 analysis or methodology in this proceeding. If and when the Department
9 implements a form of PBR that uses gas-supply savings in the computation
10 of benefits to flow to shareholders, it should put CNG on notice that the
11 Company will bear the burden of demonstrating the magnitude of the
12 savings, and proving that they are related to the merger.
13 The information the Company has provided suggests that CNG could
14 include in its estimate of gas-supply synergies improvements that could or
15 should be achievable in the absence of the merger. For example, it is not clear
16 why the savings the Company predicts from an improved leak-repair
17 program could not have been made in the absence of the merger. We have
18 only the Company's claim that NYSEG has "pursued a program of repairing
19 all leaks," that the Company could not have otherwise made itself "aware of
20 the details of NYSEG's leak repair program or its success," and that without
21 this information CNG could not have improved its loss rate (OCC-2.04).
22 **Q: Will it be possible to determine how much the Company's losses change**
23 **for year to year?**
24 A: No. The total value in the lost-and-unaccounted-for (LUF) account is the sum
25 of actual leaks, errors in estimation of unmetered gas use, metering errors,
26 and the effects of weather. Weather affects LUF in the following two ways:

1 • Colder gas is more dense and hence under-measured by non-
2 compensated volumetric meters.
3 • Much of the sendout in December is metered and billed in January of
4 the next year. Hence, calendar-year LUF is increased if December is
5 cold (since a lot of gas is sent out), and decreased if the previous
6 December was cold (since a lot of gas is metered in January). If sendout
7 is low in the rest of the year (due to mild weather or low interruptible
8 sales), the effect of the timing difference is magnified.
9 The Company has not proposed any process for segregating real reduc-
10 tions in losses from estimation, metering and weather effects.

11 **Q: Does the lack of clarity in the computation of losses offer the Company**
12 **any opportunity for gaming in its proposed rate plan?**

13 A: Yes. First, for the RPA/IRP hearings, the Company can propose a set of
14 adjustments each year for weather and other changes that tend to reduce the
15 LUF estimate, while ignoring adjustments that would increase the estimate.
16 Second, to reduce booked LUF, without actually reducing customer
17 costs, CNG could
18 • install more meters that more-accurately record gas delivery at low
19 temperatures. This would increase base revenues (50%–100% of which
20 accrue to the shareholders) and gas use for the purchased-gas adjust-
21 ment, while reducing the PGA rate (by way of a lower LUF) proportion-
22 ately. Customers as a whole would pay just as much for gas as with the
23 current meters, while shareholders would get a bonus for the reduction
24 in unaccounted-for gas.
25 • use automatic meter reading to alter reading dates and the effect of
26 weather fluctuations.

1 **Q: Please explain how the Company proposes to recover marketing costs**
2 **from ratepayers.**

3 A: The Company proposes to include payments made to customers to induce
4 fuel-switching, a category of marketing costs, as an expense in the earnings
5 test. This treatment would reduce the amount of earnings in excess of the
6 11.8% threshold and therefore the ratepayer's earnings share. As a result,
7 CNG would effectively recover a portion of incremental marketing costs
8 from ratepayers.

9 Another way to look at the Company's proposal is to note that no
10 earnings would be shared with ratepayers unless income exceeds an 11.8%
11 return, net of the marketing costs and fuel-supply synergies. In some
12 situations, shareholders would recover 100% of market costs before sharing a
13 dime of earning with ratepayers.

14 **Q: What is the Company's rationale for this treatment of marketing costs?**

15 A: In CNG's view (response to GA-283), "since the incentive is made for the
16 sole purpose of securing an incremental revenue stream in subsequent years,
17 recognition of the cost in the earnings sharing calculation is fair, balanced
18 and appropriate."

19 **Q: Why do you believe that marketing costs should not be treated as an**
20 **expense in the earnings test proposed by the Company ?**

21 A: Marketing costs should not be included in the earnings test for the following
22 two basic reasons:

23 • The increased sales growth resulting from marketing is not a merger
24 synergy, and should not increase recovery of the acquisition premium.

25 • Connecticut statute, as I understand it, prohibits recovery of marketing
26 expenses from ratepayers.

1 **Q: Why are the growth-margin savings not merger-related?**

2 A: The merger will not improve CNG's marketing capabilities. According to the
3 Company's response to OCC-2.01, all that Energy East will provide is "its
4 willingness to allow the Company to offer potential customers financial
5 incentives." CNG claims that this would be a change in policy, since CNG
6 has not been willing to offer significant financial incentives in recent years.

7 While this might be a change in behavior by the utility, it is not a
8 merger-related change. Energy East will not allow CNG to provide incentives
9 for new gas hook-ups unless CNG receives more of the benefits of the
10 revenue growth and bears less of the cost than under existing cost-of-service
11 ratemaking. If the Company offers fuel-switching incentives in the future, it
12 would be due to the fact that its proposed proposal allows it to recover those
13 incentives and retain a share of the increased revenues. Any growth due to an
14 increase in customer incentives for space heat conversions would be
15 attributable to the change in regulatory policy that allows such recovery, not
16 to the merger.

17 Even if the Department were to find that the recovery of customer
18 incentives from the ratepayer is legal and reasonable, that traditional rate
19 regulation is a barrier to sales growth, and that promotion of heating use is in
20 the interest of existing ratepayers, CNG's proposal would not provide the
21 appropriate rate treatment for growth revenues and expenses.[4]

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[4]The Company has not demonstrated that these three conditions are true. The Department should address this issue, if at all, in a proceeding in which it can take evidence on all three of these issues, as well as how the margin revenues should be shared between ratepayer and stockholder.

1 **Q: Why is CNG's proposed rate plan inappropriate for sharing the revenue**
2 **growth and expenses from space heat conversions, if it were legal?**

3 A: For the following reasons.

4 First, since the resulting revenue growth is not merger-related, none of it
5 should be diverted to recovery of the acquisition premium. Doing so is
6 contrary to the Department's finding in the Southern Connecticut Gas
7 Company rate case, Phase II:

> 8 …the Department looks to a matching of benefits and costs as an
> 9 allocation methodology in determining costs for which ratepayers
> 10 should be responsible…. The Department believes that measurable
> 11 tangible benefits for ratepayers, due to the change of control, should be
> 12 shown before ratepayers are required to contribute to the Company's
> 13 recovery of the acquisition premium. (Docket 99-04-18, 1/28/00 Phase
> 14 II Order at 43.)

15 Second, since the ratepayer will be bearing most of the costs associated
16 with the revenue growth (costs of the incentives, meters and connections, line
17 extensions, and system reinforcements), the ratepayers should receive a much
18 larger share of the benefits than they would under the Company's proposal.[5]

19 Third, extension of mains into existing neighborhoods, and investment
20 in general, increases the rate base on which CNG is permitted to earn its
21 allowed return and (in the CNG proposal) overearn by 100 basis points. This
22 further increases the costs to customers of revenue growth, and also provides
23 shareholders with an additional reward for load growth. The Department
24 should consider whether this effect diminishes incentives for cost control and
25 for adequate cost-benefit analysis of potential incentives and line extensions.

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[5] In other words, CNG overstates the revenue margin by ignoring the non-gas costs of serving the new load.

1 **V. Treatment of Acquisition Premium**

2 **Q: Does the Company's proposal meet the Department's requirements for**
3 **recovery of the acquisition premium?**

4 A: No. Explicit recognition of the acquisition premium in the earnings sharing
5 mechanism, without a demonstration of savings, violates the Department's
6 requirement for recovery of the acquisition premium from the ratepayer. As
7 stated in the Southern Connecticut Gas Company decision, the Department
8 requires

9 > measurable tangible benefits for ratepayers, due to the change of control,
10 > …be shown before ratepayers are required to contribute to the
11 > Company's recovery of the acquisition premium. (Decision in Docket
12 > No. 99-04-18 Phase II at 43)

13 **Q: Why should the acquisition premium not be charged to ratepayers?**

14 A: This topic is discussed in greater detail by other OCC witnesses. The two
15 critical points, in my view, are:

16 - The acquisition premium is not a necessary cost incurred to provide
17 service to the ratepayer.
18 - The ability of merging utilities to recover the acquisition premium from
19 ratepayers creates perverse incentives. The acquiring company would be
20 encouraged to pay a greater acquisition premium if those costs were
21 certain to be recovered from ratepayers. The increased acquisition
22 premium would then result in higher rates for customers following those
23 future mergers.

1 **VI. The Company's Need for Efficiency Incentives**

2 **Q: Has the Company demonstrated that customers will benefit from its**
3 **proposed rate plan, due to improved incentives to operate efficiently and**
4 **achieve merger savings?**

5 A: No, in two respects. First, the Company's proposal would allow shareholders
6 to retain many benefits that would normally be passed to ratepayers, and that
7 have nothing to do with efficient operation. The Company's proposal would
8 reward shareholders for efficiency improvements that would occur anyway,
9 including the results of policy decisions by the Department.

10 Second, the proposal asked that the Company be rewarded for not
11 performing worse than it would under conventional cost-of-service
12 ratemaking and prudent management. Performance-based ratemaking should
13 reward superior performance, and punish inferior performance.

14 The Company's rate plan does not start by defining the level of rates
15 under prudent management and then fashion incentives for reduction in costs
16 from that base level. On the contrary, it appears from Mr. Rude's testimony in
17 the Southern Connecticut Gas case that Energy East does not believe that it is
18 under any obligation to operate prudently unless it is bribed to eliminate
19 imprudent expenditures. Energy East will not develop merger synergies with-
20 out the incentives built into its proposed rate plan:

> 21 I will say firmly right now that we will not get to that point because we
> 22 will stop whatever merger synergy activity and consolidation activity
> 23 would be under way rather than have those savings completely
> 24 confiscated. (Rude Oral Testimony, Docket No. 99-04-18, Tr. at 3620).

25 Indeed, Mr. Rude's testimony may be read as a threat to thwart merger
26 synergies unless the Company is granted special treatment.

The imprudent and inefficient behavior described by Mr. Rude as the pre-PBR baseline should be associated with a low return on equity (reflecting the low returns achieved by badly managed firms) and with significant cost disallowances. Exemplary returns should be earned only for exemplary performance.

VII. Design of Performance-Based-Ratemaking Plans and Rate Caps Following Mergers

Q: How should PBR plans be designed?

A: Performance-based-ratemaking mechanisms can be designed in a number of ways, but they typically take the form of a rate plan that fixes allowed rate or revenue levels over three to five years, subject to the following:

- annual adjustments for inflation,
- an offset for productivity improvements,
- sharing of excess earnings,
- provisions for the treatment of specific identified exogenous costs,
- clear "off-ramps" detailing the circumstances under which the plan would revert to traditional ratemaking.

Within the rate plan, the utility may retain for shareholders a share of cost decreases, and will absorb most cost increases, beyond those locked into the plan. In addition, PBR plans generally set performance incentives, to ensure that the utility does not profit from cost cuts that impede service quality and other regulatory and policy objectives.[6]

[6] Biewald et al. provide a broad overview of performance-based ratemaking at 8–10.

1 **Q: What particular concerns should the Department have in implementing**
2 **a post-merger PBR?**
3 A: The PBR should be designed to place on shareholders the risk that the merger
4 will not reduce costs, while allowing both shareholders and customers to
5 benefit from efficient mergers. Improperly designed, a post-merger PBR may
6 harm ratepayers by denying them savings that would have occurred as a
7 matter of course. Those savings may result, for example, from continuing
8 efficiency improvements flowing from technology for which customers are
9 paying in current rates, from adoption of best practices within the industry,
10 and from reduced input prices. In normal cost-of-service ratemaking, those
11 savings would flow through to ratepayers. In order to be equitable, as well as
12 efficient, any PBR scheme must allow ratepayers to benefit from these
13 savings.[7]

14 **Q: How can these concerns be addressed in the design of a post-merger**
15 **PBR?**
16 A: The merger should be the starting point for the rate plan and the PBR
17 mechanism should be designed to further reduce costs and concentrate the
18 associated risks and rewards on the utility. The effect of the mergers can be
19 taken into account in several parts of the development of a PBR plan, as
20 follows:
21 - Reflecting initial merger savings in the initial rates.

[7]Biewald et al. (at 34) emphasize the importance of avoiding a situation in which PBR is a windfall for merging companies, and a deadweight loss for ratepayers. The authors suggest the following measures: (1) conducting rate-case type scrutiny of the initial rates approved for the combined entity; (2) using a high productivity factor for the years of maximum post-merger savings; (3) sharing earnings above the required return more rigorously in the post-merger years; and (4) locking estimated merger savings into the initial post-merger rates.

1 • Reducing annual rate changes by a productivity factor that explicitly
2 accounts for
3 • general industry productivity trends,
4 • anticipated continuing merger-related cost reductions,
5 • the incentive effects of the PBR plan,
6 • any other foreseeable changes in costs and revenues.[8]
7 • Distinguishing in the earnings-share mechanism between merger-related
8 and non–merger-related cost savings and revenue growth.
9 • Ensuring that ratepayers receive a significant share of excess earnings
10 due to higher-than-expected merger savings (Biewald et al. at 34).
11 The Company's proposal does not explicitly address the merger with respect
12 to any of these areas.

13 **Q: Have you reviewed the rate plans from other utility mergers?**

14 A: Yes. Exhibit PLC-3 tabulates the major features of 68 rate plans proposed or
15 ordered in 42 mergers. Eighteen of the mergers involve combination gas and
16 electric utilities. This is not a comprehensive summary of all utility mergers
17 in the last dozen years, but I believe this survey to be representative. I have
18 not been able to assemble comparable data for the remainder of the
19 approximately 100 mergers proposed or approved in that time period.

20 **Q: What does the information in Exhibit PLC-3 indicate about the range of**
21 **rate plans following mergers?**

22 A: There are many ways of setting up rate plans, consisting of essentially four
23 categories: a rate reduction, a ratemaking credit (which usually continues for
24 some years), a rate freeze only, and the combination of an immediate rate

[8]An example of this last category is the revenue affect of the Department's recent decision on cost-of-service allocations.

1 reduction with a freeze. Many of the rate plans contain immediate rate
2 reductions. The plans that have been put in place by other utilities cast doubt
3 on the adequacy of the simple rate freeze that CNG has proposed, in
4 providing ratepayers with an adequate share of merger savings and
5 productivity improvements.

6 **Q: Does this complete your testimony at this time?**

7 A: Yes.