STATE OF CONNECTICUT

BEFORE THE DEPARTMENT OF PUBLIC UTILITY CONTROL

Review of the United Illuminating	**)**	
Company's Rate Filing and	**)**	**Docket No. 01-10-10**
Rate Plan Proposal	**)**	

DIRECT TESTIMONY OF

PAUL CHERNICK

ON BEHALF OF

THE OFFICE OF CONSUMER COUNSEL

Resource Insight, Inc.

APRIL 3, 2002

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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) and cost recovery in restructured gas and electric industries. My resume is attached as Exhibit PLC-1.

Q: Have you testified previously in utility proceedings?

A: Yes. I have testified approximately one hundred and eighty 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 (and its successor, the Department of Telecommunications and Energy), Massachusetts Energy Facilities Siting Council, Michigan Public Service Commission, Minnesota Public Utilities Commission, Mississippi Public Service Commission, New Jersey Board of Public Utilities, 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.

Q: Have you testified previously before the Connecticut Department of Public Utility Control (the DPUC or the Department)?

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.
- The initial phase of this 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.
- Docket No. 99-09-03, on the performance-based ratemaking proposal of Connecticut Natural Gas.
- Docket No. 99-09-12 RE01, on the Millstone auction.
- Docket No. 99-03-36 RE03, on CL&P's Generation Services Charge.
- Docket No. 99-04-18 Phase 3 and Docket No. 99-09-03 Phase 2, on the earnings sharing mechanism proposed by Connecticut Natural Gas and Southern Connecticut Natural Gas.

Q: Are you the author of any publications on utility planning and ratemaking issues?

A: Yes. I am the author of a number of publications on rate design, cost allocation, cost recovery, cost-benefit analysis, and other ratemaking issues. Several of my recent papers and reports deal with issues in electric and gas industry restructuring, including integrated resource planning and performance-based ratemaking.

II. Introduction

Q: On whose behalf are you testifying?

A: I am testifying on behalf of the Connecticut Office of Consumer Counsel (OCC).

Q: What is the purpose of your testimony?

A: I was asked to review the rate plan proposed by United Illuminating (UI or the Company) .

Q: Please summarize your testimony.

A: I discuss the following aspects of the Company's proposal:

- A change in the allocation in excess earnings between shareholders and ratepayers.
- A proposed off-ramp for when return on earnings fails to reach 10.5%, which is just 100 basis points below the target level.
- The use of reversals of accelerated depreciation to increase UI's earnings.
- The effect of reduced regulatory lag on UI's required return (in support of OCC's return witness).
- The relevance to the rate plan of UI's proposed power-cost adjustment charge and the recent change in UI's power-supply arrangements.

Q: Please summarize your conclusions and recommendations.

A: The Company's proposal increases the benefits to shareholders when earnings are high, compared to the existing rate plan, while reducing benefits and increasing risks to ratepayers. It would eliminate the potential for current rate reductions, reduce amortization of stranded costs (while still reserving the right to take back the small remaining amortizations), establish an asymmetric off-ramp, and impose a purchased-power cost adjustment. Even though the

Company has recently changed its power supplier, it proposes to shift all the costs and risks of that transition to its customers while retaining half of any positive outcomes over the next five years.

Q: Please summarize your recommendations.

A: I recommend that the Department

- maintain or increase the share of excess earnings allocated to ratepayers.
- create an off-ramp from the rate plan, if UI's actual or projected return on equity (ROE) rises above some trigger level, such as 200 basis points above the target return.
- only allow UI to reverse accelerated amortization during the period before the Company exercises its right to file for rate relief. Once the Company files for rate relief, no further reversals should be allowed.
- subject any changes in amortization to DPUC oversight. This could take the form of an addendum to one of the Company's periodic earnings reports to the Department, with sufficient information to demonstrate compliance with the Department's relevant orders in this proceeding.
- condition any rate plan on the results of a future review of the prudence of UI's (1) management of its power supply arrangement with Enron, (2) management of its power supply arrangement at the time of Enron's collapse, and (3) choice of a replacement power supplier. Specifically, the Department should determine that any portion of excess earnings that is allocated to shareholders will remain conditional, and may be used to compensate ratepayers for any imprudence in UI's power-supply activity.

III. Elements of the Rate Plan

A. Allocation of Excess Earnings

Q: How does UI propose to change the allocation of earnings in excess of the return authorized by the Department?

A: In the rate plan previously authorized by the Department, excess earnings were allocated one-third to shareholders and two-thirds to ratepayers, of which one-third was to fund current rate reductions and the other third was to accelerate amortization of stranded costs. The Company's current proposal would increase the shareholder portion to half the excess earnings and eliminate the current rate reductions. The ratepayer share would be used only to reduce stranded costs.

Q: How large is this change in allocation of excess earnings?

A: The Company's proposal would increase the shareholder portion of excess earnings by 50% (from one-third to one-half).

Q: What is UI's rationale for this large increase in the payoff to shareholders?

A: Company Witness Gregory E. Sages asserts:

> [T]he rate plan provides the Company with a clear incentive to seek out and undertake further cost reduction initiatives, while maintaining high quality of service. Thus the interests of customers and shareowners will remain aligned for the duration of the rate plan period, as they have been for the past five years. The change to a 50/50 sharing mechanism will accelerate the reduction in stranded cost balances. To the extent that actual earnings are over UI's authorized return on equity, customers will benefit from the first dollar sharing by reducing stranded cost balances, which reduces the period over which rates will need to cover the amortization of these stranded costs as well as reducing the total cost to customers. (Sages Direct at 8)

Q: Has the Company demonstrated that the increase in the shareholder portion of excess earnings is required to "provide the Company with a clear incentive to seek out and undertake further cost reduction initiatives"?

A: No. The Company has not offered any evidence that larger incentives are required.

Many components of the Company's proposal would suggest that smaller shareholder incentives should be adequate. The Company is not being asked to invest shareholder funds in risky ventures to reduce ratepayer costs; investments would be recoverable through rates. The Company would be able to file a rate case if it ever projected that return on equity might fall 100 basis points below the target ROE, and in the meantime could reverse scheduled accelerated amortization to maintain its ROE. The Company has also requested a purchased-power adjustment, further reducing risks to UI and to UI shareholders. In the low-risk environment UI is facing, management should not require large incentives to do the job for which it paid by the ratepayers: provide quality service at minimum cost.

Q: Has the Company demonstrated that the increase in the shareholder portion of excess earnings would "provide the Company with a clear incentive...to maintain high quality of service?"

A: No. The Company has not offered any evidence that giving shareholders a larger portion of excess earnings would increase UI's interest in maintaining or improving the quality of service.

To the contrary, the higher shareholder share of excess earnings would tend to increase management's temptation to reduce spending, even at the cost of degraded service quality. This is particularly true in the absence of any financial consequences or incentives for failing to maintain service quality.

Q: Is Mr. Sages correct that the "change to a 50/50 sharing mechanism will accelerate the reduction in stranded cost balances"?

A: Not really. The change to a 50/50 sharing between ratepayers and shareholders does nothing to accelerate the reduction in stranded-cost balances. Any acceleration is due to the use of the entirety of the smaller ratepayer share to reduce stranded costs.

Compared to the current plan, customers would lose $2 in rate reductions for every $1 of accelerated amortization. Near-term rates would rise twice as much as stranded costs would decrease. This tradeoff is not one that most ratepayers would accept.[1]

Q: Is Mr. Sages correct when he says that trading two dollars of current rate reductions for one dollar of accelerated amortization "reduces the total cost to customers?"

A: No. Customers would be better off with two dollars of rate reduction, rather than one dollar of potential future benefits.

Q: Is this an appropriate time to increase rates to increase amortization of stranded costs?

A: No. The Company is also proposing a change in accounting for normally capitalized overheads that increases operations and maintenance expenses by $3.8 million annually (Sages Direct at 13). The effect of this change would be very similar to reducing current ratepayer benefits to accelerate amortization of stranded costs.

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[1]For example, suppose that UI over-earns by $6 million. Under the existing rate plan, the ratepayers would receive $2 million in deferrals and $2 million in rate reductions. Under UI's proposal, the ratepayers would lose the $2 million in rate reductions, which would be only partly offset by a $1 million in deferrals.

B. Off-Ramp for Reduced Earnings

Q: Under what conditions would the Company's proposed rate plan be terminated by a new rate case?

A: Mr. Sages summarizes the proposed off-ramp as follows:

> UI can seek rate relief in the event that...the Company's projected return on equity on a forward-looking twelve-month basis is less than 10.5%.... (Sages Direct at 7)

Q: Is this an appropriate standard?

A: No. The proposed ROE off-ramp is inappropriately asymmetrical, since it would apply when UI's projection of ROE falls below the target level, but not when ROE rises above the target level. The proposed off-ramp would also be set just 100 basis points below the target level. And since the off-ramp is triggered by the Company's own projection of its ROE over the next twelve months, UI could file for a rate increase in plenty of time to have higher rates in effect before annualized ROE actually fell below 100 basis points below the target.

Q: Under what conditions would the proposed rate plan require UI to file for a rate decrease?

A: The Company would never be required to reduce rates during the five-year rate-plan period.

Q: What is the effect of the off-ramp portion of the proposal?

A: The Company's proposal would give shareholders more of the upside of variation in return than in the current rate plan, while exposing shareholders to little risk of the downside. Return varies due to both management decisions and exogenous events (including weather, the economy, and changes in law and regulation), so shareholders would be rewarded for simple good luck, while passing to ratepayers most of the costs of anything that goes wrong.

C. Accelerated Amortization of Stranded Costs

Q: How does The Company propose to treat the schedule for accelerated amortization of stranded costs?

A: The Company proposes to reduce the rate of amortization of stranded costs compared to recent years (Sages Direct at 6). In addition, UI proposes to take back any scheduled amortization of stranded costs, to maintain its ROE at 10.5% (Sages Direct at 7).

Q: What is the effect of these proposals?

A: To the extent that the Company has overestimated its costs or underestimated revenues, and hence underestimated the amount available to amortize stranded costs, it would give to shareholders 50% of the additional excess earnings that would occur when the lower costs (or higher revenues) materialized. Had UI reflected lower costs or higher revenues in determining the amortization schedule, 100% of the reduced costs would have benefited ratepayers.

The reversal of the scheduled amortization further increases the assurance that UI will never earn less than 10.5% ROE. These reversals would be required only while a rate-increase application was pending.[2]

IV. Power-Cost Issues and the Rate Plan

Q: How do power-cost issues bear on the Rate Plan?

A: There are two such issues: the Company's proposed power-cost adjustment charge and the recent change in UI's power-supply arrangements.

[2]The Company proposes small levels of accelerated amortization; those values may be raised by the Department following review of UI's projections of expenses and UI's claimed required ROE.

Q: How would UI's proposed power-cost adjustment charge affect current and future rates?

A: The Company has not provided any analysis of such effects. However, the power-cost adjustment charge would almost certainly shift risks from the shareholders to ratepayers.

Q: How did the Company's previous power-supply arrangement affect UI and its customers?

A. In Docket No. 99-03-35, the Department approved a power-supply arrangement between UI and Enron to cover UI's obligation to provide a power supply to meet customers' needs for the standard offer period ending December 31, 2003. The power-supply contract proposed by UI and Enron had a number of desirable features, as summarized by the Department in Docket No. 99-03-25 (at 8–9):

> UI's generation services charges would be set at [fixed prices] for the SOS period January 1, 2000, through December 31, 2003.
>
> No fuel and very limited energy cost adjustments would affect the generation component of UI's SOS rates.
>
> UI's customers would bear no risk of future changes in fuel prices or wholesale energy market prices.
>
> UI's purchased power adjustment charge...would be set at zero, unless a modification of the present array of Independent System Operator (ISO) products or the implementation of renewable energy requirements causes a change in UI's SOS supply costs.
>
> UI will pay Enron to assume UI's interests in the Bridgeport-RESCO, Shelton Landfill, Derby Hydro and PASNY power purchase contracts (either through a direct assignment with the counterparty's consent or through a back-to-back power purchase from UI). This has the effect of UI buying out its obligation under these contracts for a value of approximately $144.4 million (net present value).
>
> Enron will purchase the remaining firm energy contract deliveries associated with UI's Hydro-Quebec entitlement at cost.

This purchased-power arrangement placed most of the risks of fluctuating market prices on Enron, rather than on UI customers.[3]

Q: How will the termination of the Enron contract and the initiation of the Dominion contract for standard-offer service affect current and future rates?

A: The Company has refused to provide any information on this subject in this docket (IRs OCC-177, -179, -180, -181, -182).

Q: Did UI prudently manage the decision to terminate the Enron contract, the transition from Enron, the search for new suppliers, the conduct of the auction for the standard-offer supply and the selection of Dominion?

A: The Company has refused to provide any information on this subject in this docket (IR OCC-178).

Q: How should these issues be reflected in the design of the Rate Plan?

A: First, the Rate Plan should not include any Purchased Power Adjustment Clause unless and until UI has presented a specific PPAC proposal and the Department has carefully reviewed that proposal. As part of that review, UI should demonstrate the prudence of its new power-supply contract, and identify the nature of any risks in power costs that would flow through the PPAC.[4]

Second, if the Department authorizes a Rate Plan including a PPAC, it should reflect the benefits to UI and the risks imposed on ratepayers from establishment of a proposed power-cost adjustment.

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[3]Enron's default shifts those risks back to UI. It is not clear to what extent Dominion has assumed the same risks, and whether, for example, UI is now liable for the above-market costs of contracts it thought it had shifted to Enron.

[4]Those risks may flow directly from the terms of the Dominion contract, or from the other contracts that UI paid Enron to assume, but that have reverted to UI.

Third, UI's target return on equity and management compensation should reflect the quality of the Company's management decisions, including power-supply decisions.

V. Effect of the Company's Proposal on Required Return

Q: How would implementation of the Company's proposal affect its required return on equity?

A: The following features of the plan would reduce risk to UI and its shareholders:

- reducing scheduled amortization;
- creating an asymmetric off-ramp, based on Company-projected return;
- increasing the shareholder portion of excess earnings;
- imposing a purchased-power supply adjustment.

Q: Has UI quantified these effects and reduced its target ROE appropriately?

A: No. See responses to IRs OCC-173, -174, and -175.

Q: Does this conclude your testimony?

A: Yes, at this time.