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September 10, 2007

Mary L. Cottrell, Secretary
Department of Public Utilities
One South Station, 2nd Floor
Boston, MA 02110

Re: Investigation by the Department of Public Utilities on its own Motion into Rate Structures that will Promote Efficient Deployment of Demand Resources- D.P.U. 07-50

Dear Ms. Cottrell:

Enclosed herewith for filing with the Department of Public Utilities (the "Department") are the Initial Comments of NSTAR Electric Company and NSTAR Gas Company (together, "NSTAR" or the "Company") in the above-referenced proceeding. Consistent with the Department's directives, the Company intends on presenting the jointly sponsored testimony of the following panelists at the Department's hearing:

John J. Reed, Chairman and Chief Executive Officer of Concentric Energy Advisors

James D Simpson, Vice President, Concentric Energy Advisors

Lawrence Kaufmann, Ph.D., Partner, Pacific Economic Group, LLC

NSTAR also anticipates that a company representative will participate on the Department's panels. Through these panelists, the Company anticipates offering testimony on the issues of (1) implementing revenue decoupling in conjunction with long-term rate plans; (2) the need to maintain PBR and other cost-recovery mechanisms (including reconciling mechanisms) in conjunction with revenue decoupling; (3) ratemaking methodologies to be considered in future base-rate proceedings to ensure recovery of allowed revenue requirements over multi-year periods without revenues associated with system growth; and (4) the impact of revenue decoupling, if any, on a utility's allowed rate of return.

The Company may take the opportunity to amend or supplement its statement as to panelists and anticipated topics based on a review of comments filed on this date, but will do so no later than Friday, September 14, 2007.

Please contact me or Robert Werlin if you have any questions regarding this request. NSTAR greatly appreciates the opportunity to comment on this important policy matter.

Very truly yours,

Robert J. Keegan

cc: Jeanne Voveris, Senior Counsel
Department Service List, D.P.U. 07-50

Enclosures

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF PUBLIC UTILITIES

Investigation by the Department of Public Utilities on its Own Motion into Rate Structures that Will Promote Efficient Deployment of Demand Resources	)))))	D.P.U. 07-50

EXECUTIVE SUMMARY

NSTAR Electric Company and NSTAR Gas Company strongly support the Department's effort to implement decoupling for Massachusetts utilities in order to eliminate ratemaking incentives that work against energy efficiency and demand response initiatives. Under existing Massachusetts utility ratemaking practice, electric and gas distribution companies have an inherent incentive to maintain and/or increase sales in order to generate the revenues necessary to offset increasing operations and maintenance ("O&M") expenses and fund needed system reliability and capital expansion projects between rate cases. The implementation of a workable decoupling mechanism would render utilities neutral to changes in sales volumes occurring as a result of conservation, and therefore, will eliminate a potential barrier to the cost-effective implementation of conservation and load-management strategies across the Commonwealth. This is an important objective that should be fulfilled on an expeditious basis.

As delineated in the order opening this inquiry, there are two principal elements of the Department's straw proposal, which are (1) the conduct of future base-rate proceedings to analyze revenue requirements and set "just and reasonable" revenue targets; and (2) the implementation of an annual reconciliation methodology to ensure recovery of the revenue target set in that proceeding In these comments, NSTAR generally supports the second element of the

Department's straw proposal, which is the annual reconciliation methodology. The annual reconciliation methodology is reasonable and appropriately designed to achieve the objective of rendering a utility neutral to changes in sales volumes, although it is designed to account for growth in the number of customers, but not for growth in usage per customer. As discussed herein, NSTAR believes that this issue may be addressed through the ratemaking process in future base rate proceedings.

From NSTAR's perspective, a significant issue is raised in relation to the first element of the Department's straw proposal, which is the proposition that it will be necessary to complete a fully litigated base rate proceeding for every utility in the Commonwealth before revenue decoupling can be instituted on a statewide basis. As discussed below, it is not necessary or appropriate to reset base rates or to eliminate existing cost-recovery mechanisms in order to accommodate revenue decoupling. The implementation of revenue decoupling simply requires the Department to set a revenue target consistent with the rates in effect and already determined by the Department to be just and reasonable under G.L. c. 164, § 94. The setting of a revenue target outside of a base-rate proceeding (and consistent with existing rate plans) is well within the Department's statutory authority and ratemaking expertise, and would allow for the expeditious implementation of a revenue-decoupling mechanism on a statewide basis in order to eliminate barriers to increased conservation. Conversely, the relatively straightforward process of implementing a revenue-decoupling mechanism is likely to become a long, costly and arduous process for the electric and gas companies, the Department and a broad range of participating interests, if implemented as envisioned by the Department. This approach also has the potential to cause significant financial disruption to companies now and in the future because of what the market will perceive as a highly uncertain regulatory environment. In these comments, NSTAR

offers recommendations to avoid this outcome and to implement revenue decoupling on a workable and expeditious basis, while also achieving the Department's broader goals and objectives over the longer term. These recommendations are as follows:

- → Maintain Existing Cost-Recovery & Incentive Mechanisms: The Department should find that its proposed annual reconciliation mechanism may be implemented in conjunction with established cost recovery mechanisms, such as PBR or long-term rate plans, which have been found "just and reasonable" in prior ratemaking proceedings. The Department should also find that reconciling cost-recovery mechanisms should not be modified by revenue decoupling. These mechanisms apply to volatile costs, large in magnitude and beyond the control of the companies; and in addition, are already neutral to fluctuations in sales volumes.

- → Expeditious Implementation of Revenue Decoupling: The Department should require each electric and gas company to submit a company-specific proposal by a date certain to establish an appropriate revenue target so that revenue decoupling may be implemented on an expeditious basis. Depending on the distribution company's specific circumstances, the revenue target could result from a base-rate proceeding or from the Department's approval of a revenue target demonstrated to be consistent with a PBR or long-term rate plan currently in effect.

- → Revenue Neutral Implementation Consistent With Long-Term Rate Plans: To the extent that rate-design changes are necessary or desirable to implement revenue decoupling where a long-term rate plan is in place, the Department should allow companies to make a revenue-neutral proposal consistent with that rate plan.

- → Annual Reconciliation: Once a revenue target is set, the Department should implement its proposed annual reconciliation methodology to reconcile revenues to the established revenue target.

- → Monitoring Results: The Department should adopt its proposed annual earnings-sharing calculation to monitor and assess whether the approved revenue target and annual reconciliation mechanism are operating as planned. Earnings sharing provisions that are contained in currently effective long-term rate plans should be adhered to for the duration of those plans.

- → Future Ratemaking Proceedings: In base-rate proceedings to establish a revenue target or following the expiration of a long-term rate plan, the Department should review the distribution revenue requirement and allocation of the revenue requirement among customer classes through an allocated cost of service study, in order to achieve its policy goals of ensuring an efficient pricing structure. The Department should also consider new ratemaking approaches that provide for recovery of allowed revenues in the absence of growth in usage per customer, which has historically been available to the utility to offset costs and fund utility investment.

COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF PUBLIC UTILITIES

Investigation by the Department of Public Utilities on its Own Motion into Rate Structures that Will Promote Efficient Deployment of Demand Resources	)))))	D.P.U. 07-50

INITIAL COMMENTS OF NSTAR ELECTRIC COMPANY AND NSTAR GAS COMPANY

I. Overview

On June 22, 2007, the Department of Public Utilities (the "Department") issued a notice of inquiry opening an investigation into rate structures and revenue recovery mechanisms that may reduce disincentives to the efficient deployment of demand resources in Massachusetts (the "NOI"). NOI at 1. The Department's proposal to implement a revenue-decoupling mechanism recognizes that, under current ratemaking practice, electric and gas companies have a strong incentive to take actions to maintain or increase sales in order to ensure an adequate flow of revenues between base rate proceedings. Id. at 2. The Department's NOI also recognizes that there is an inherent conflict between the incentive to increase sales and the existence of important state, regional and national goals to increase end-use efficiency and minimize the environmental impacts of energy production and consumption. Id. at 2-3. Accordingly, the Department's NOI finds that this inherent conflict "must be addressed expeditiously" through the implementation of a revenue-collection mechanism that renders utility revenue levels neutral to changes in sales volumes between rate proceedings, in order to eliminate barriers to the deployment of cost effective demand resources. Id. at 3.

To facilitate the implementation of revenue decoupling, the Department presented a "straw proposal" for a base revenue adjustment mechanism, which would render electric and gas companies' revenue levels neutral to changes in sales between rate proceedings. Id. at 3. According to the Department, the objective of the base revenue adjustment mechanism is to "eliminate the current financial disincentive that electric and gas companies face regarding the deployment of customer-sited, cost-effective demand resources in their service territories." Id. at 11. As delineated in the NOI, there are two principal elements of the Department's straw proposal, which are (1) the conduct of future base-rate proceedings to analyze revenue requirements and set "just and reasonable" revenue targets; and (2) the implementation of an annual reconciliation methodology to ensure recovery of the revenue target set in that proceeding. Id. at 4-5. NSTAR Electric Company and NSTAR Gas Company (collectively, "NSTAR" or the "Company") address each of these two elements below.

As an initial matter, NSTAR strongly supports the Department's effort to implement decoupling for Massachusetts utilities in order to eliminate ratemaking incentives that work against energy efficiency and demand response initiatives. Under existing Massachusetts utility ratemaking practice, electric and gas distribution companies have a strong incentive to maintain and/or increase sales in order to generate the revenues necessary to offset increasing operations and maintenance ("O&M") expenses and fund needed system reliability and capital expansion projects between rate cases. The implementation of a workable decoupling mechanism would render utilities neutral to changes in sales volumes occurring as a result of conservation, and therefore, will eliminate a potential barrier to the cost-effective implementation of conservation and load-management strategies across the Commonwealth.

In that regard, the annual reconciliation methodology that constitutes the second element of the Department's straw proposal is reasonable and appropriately designed to achieve the objective of rendering a utility neutral to changes in sales volumes.

A significant issue raised in relation to the first element of the Department's straw proposal, however, is the proposition that it will be necessary to complete a fully litigated base rate proceeding for every utility in the Commonwealth before revenue decoupling can be instituted on a statewide basis. As discussed below, it is not necessary or appropriate to reset base rates or to eliminate existing cost-recovery mechanisms in order to accommodate revenue decoupling. The implementation of revenue decoupling simply requires the Department to set a revenue target consistent with the rates in effect and already determined by the Department to be just and reasonable under G.L. c. 164, § 94. As discussed below, the setting of a revenue target outside of a base-rate proceeding is well within the Department's statutory authority and ratemaking expertise, and would allow for the expeditious implementation of a revenue-decoupling mechanism on a statewide basis in order to eliminate barriers to increased conservation.

From the NOI, it appears that the Department's desire to approach revenue decoupling in the manner proposed (i.e., only after the completion of a base-rate proceeding) follows from a desire to address policy objectives other than energy conservation and that are not necessarily implicated by the implementation of a workable revenue-decoupling mechanism. In attempting to address goals and objectives outside the scope of revenue decoupling, the Department virtually ensures that the implementation of revenue decoupling will be a long, costly and arduous process for the electric and gas companies, the Department and a broad range of participating interests, while also causing significant financial

disruption to companies now and in the future because of what the market will perceive as a highly uncertain regulatory environment. In these comments, NSTAR offers recommendations to avoid this outcome and to implement revenue decoupling on a workable and expeditious basis, while also achieving the Department's broader goals and objectives over the longer term.

To that end, the Company's comments below are organized as follows: Section II provides an overview of NSTAR's customer base, rate structure and existing energy efficiency programs. Section III responds to the Department's straw proposal in terms of (1) the establishment of an appropriate revenue target; and (2) implementation of an annual revenue reconciliation methodology. In Section IV, the Company provides specific responses to the 12 questions posed by the Department in its Order.

II. Overview of NSTAR's Operations

A. Customer Base and Historical Customer Growth

NSTAR Electric currently serves approximately 1.1 million customers in 81 cities and towns, including approximately 970,000 residential customers and 153,000 commercial and industrial customers ("C&I"). In total, C&I volumes account for 69 percent of the Company's total electric load.

NSTAR Gas serves approximately 255,000 customers in 53 cities and towns, including approximately 233,000 residential customers and 22,000 C&I customers. In total, C&I volumes account for 56 percent of the Company's total natural gas load.

The Company's gross revenues in 2006 totaled $3.1 billion for the electric companies and $513 million for the gas company, of which the Company collected $737 million in electric delivery revenues and $131 million in natural gas delivery revenues.

For purposes of this proceeding, it is important to note that the sales growth historically experienced by the Company is the result of growth in the number of customers, but also growth in *usage per customer*, which is not accounted for in the Department's straw proposal. Specifically, the Company has experienced growth in usage per customer in some of the larger C&I classes on both the electric and gas sides, and historically, in the residential and small C&I customer classes in the electric side. Average growth in usage per customer per year by customer class over the period 1999 through 2006, is as follows:

Class	BECo	COM	CAM	NSTAR Gas
Residential	1.1%	1.2%	0.5%	-1.5%
C&I	-0.3%	0.0%	1.8%	-0.9%
Total	0.7%	1.0%	2.3%	-1.0%

Whether resulting from growth in the number of customers or growth in usage per customer, the Company relies on the growth in sales revenues between rate cases to offset rising O&M costs and to fund needed system investment. In adjusting for the number of customers on a system from year to year, the Department's model accounts for only a part of the growth in sales volumes that is currently available to recover the allowed revenue requirement on a year-to-year basis. Accordingly, if the Department implements the straw proposal as delineated in the NOI, the Department's ratemaking process will need to account for the loss of the revenue stream associated with growth in usage per customer in order to render companies neutral to changes in sales volumes.

B. NSTAR Rate Recovery

Currently, NSTAR Electric is operating under a 7-year rate plan that commenced on January 1, 2006, pursuant to the Department's approval in NSTAR Electric, D.T.E. 05-85

(2005) (the "D.T.E. 05-85 Settlement"). The NSTAR Electric rate plan does not include a traditional performance-based ratemaking ("PBR") plan, but does include cost-recovery elements similar to a PBR plan, including annual increases for inflation less a consumer offset, exogenous cost recovery, earnings sharing and service-quality requirements. Under the D.T.E. 05-85 Settlement, NSTAR Electric is also able to recover the costs it incurs relating to underground distribution system safety and double-pole removal (the "CPSL Program"). NSTAR Gas is operating under a traditional cost-of-service rate framework, with its most recent base-rate proceeding occurring in 1992. NSTAR Gas is not currently subject to PBR, although the Company anticipates that it will be making a request for base-rate relief and a PBR proposal within the foreseeable future.

Since the creation of NSTAR in 1999, following the merger of Boston Edison and the Commonwealth Energy system, NSTAR has invested over $1.7 billion in its electric distribution infrastructure, or approximately $250 million per year on average and approximately $220 million in the gas distribution infrastructure, or approximately $50 million per year on average. Infrastructure investment is vital to the Company's ability to maintain safe and reliable service to customers over the long term. However, the Company's infrastructure investment is funded entirely through rates, and because the cost of the Company's construction and maintenance activities is highly sensitive to inflationary pressures (i.e., replacement of a fully depreciated unit is at a price more than five times the original cost), the Company is faced with a persistent challenge in maintaining sufficient investment levels through a combination of cost management, revenue recovery and reliance on system growth. In addition, because depreciation is based on gross fixed assets rather than net fixed assets (which is a rough proxy for rate base), depreciation expense increases at

a rate that far exceeds increases in rate base. Accordingly, one of the Company's key objectives in this proceeding is to ensure that the Department establishes a revenue decoupling mechanism that will not undermine the Company's ability to obtain adequate funding for its required and needed infrastructure maintenance and upgrade projects.

C. Energy Efficiency Programs

The Company currently offers a wide range of efficiency programs for the residential, commercial and industrial sectors. In the residential sector, the Company administers programs involving new construction and retrofit services (MassSAVE), as well as new energy efficient lighting and appliance programs and educational support. For the C&I sectors, the Company offers programs involving new construction, business and small business solutions and demand response, as well as new energy efficient equipment and educational support. The Company's programs have yielded significant results at current funding levels in terms of overall energy savings. The historical energy savings resulting from the Company's programs are shown in Table 1, below:

Table 1

NSTAR's Historical Efficiency Results				
	Residential (inc. low-		Commercial & Industrial	
Year	Energy (MWh)	Summer Peak (MW)	Energy (MWh)	Summer Peak (MW)
1998	30,098	5.7	60,733	14.5
1999	24,715	3.3	67,600	16.2
2000	26,085	3.3	76,403	16.5
2001	30,440	3.4	73,889	16.7
2002	24,036	3.0	82,705	17.9
2003	34,300	4.5	96,586	16.8
2004	58,317	9.4	123,725	21.6
2005	80,397	7.8	120,613	19.7

In its 2006 plan, NSTAR established program goals of nearly 1,700 GWh of lifetime savings, which represents an increase over historical results without any change in the funding mechanism. The Company estimates that its 2006 programs will be highly cost-effective, with a benefit-cost ratio of 5.3. More importantly for purposes of this proceeding, the Company agrees with the broad consensus that there is significant potential for incremental efficiency gains. Although reduction estimates vary, many stakeholders believe that increased energy efficiency strategies, if aggressively pursued, could successfully offset expected load growth from 2008 to 2017, reducing an estimated load of 25,100 GWh in 2017 to 19,800 GWh. This is a significant result that will require increased (but cost-effective) investment and the elimination of barriers that currently exist in the utility ratemaking scheme.

III. Response to the Department's Straw Proposal

A. Introduction

From an overall perspective, the fundamental purpose of revenue decoupling is simply to ensure that a target level of revenues is collected regardless of the level of sales volumes experienced by the company. Implementation of a revenue-decoupling mechanism makes sense where there is a recognition that sales volumes vary over time because of conservation, energy efficiency, economic cycles, weather and other variables and that it is often exceedingly difficult to isolate the impact of one variable or another on sales volumes over time. Therefore, if barriers to energy-efficiency investment are to truly be eliminated, the utilities' recovery of its target revenue requirement must be rendered neutral to changes in sales volumes. As a reconciliation mechanism, revenue decoupling is a relatively straightforward and easy concept to implement in order to further conservation objectives. It

simply requires that actual revenue collections be reconciled to a target level of revenue and that any over or under recovery be recovered from or returned to customers in a succeeding period.

In its Order, the Department presents a "straw proposal" for a base revenue adjustment mechanism designed to achieve the central objective of revenue decoupling, which is to "better align the financial interests of electric and gas companies with customer interests, demand resources, price mitigation, environmental and other policy objectives" and to eliminate the barriers to conservation that are inherent in the existing ratemaking process and revenue-collection methods in place for Massachusetts utilities. NOI at 10-11. As delineated in the NOI, there are two principal elements of the Department's base revenue adjustment mechanism, which are (1) the setting of "just and reasonable" revenue targets through future base rate proceedings establishing new revenue requirements; and (2) the implementation of an annual reconciliation methodology to ensure recovery of the established revenue target. Id. at 4-5. Thus, consistent with the overall design of revenue-decoupling mechanisms in place in other jurisdictions, the Department's straw proposal is intended to first set an overall revenue target (disaggregated into "allowed revenue per customer"), and then second, to ensure the recovery of that target through an annual reconciliation process so that fluctuations in sales volumes are no longer part of the ratemaking equation.

For NSTAR Electric (and other gas and electric distribution companies in the Commonwealth), the Department's straw proposal raises three overarching concerns. First, the Department's straw proposal anticipates that the setting of a "revenue target" can only occur within the context of a fully litigated, future base-rate proceeding involving a full

review of a company's cost of service, cost allocation methodology, and rate design to arrive at an "allowed revenues per customer." Id. at 4, 13, 14. This is not the case, and in this respect, the process by which the Department proposes to establish a utility's revenue target for revenue decoupling purposes promises to be a much more controversial, complicated, time-consuming and costly proposition than it needs to be.

Second, the Department's straw proposal suggests that, once a base-rate proceeding is concluded and the revenue-decoupling mechanism is put in place, cost recovery mechanisms that currently work in conjunction with established base rates to ensure recovery of the allowed revenue requirement over time, such as PBR and reconciling charges for pension costs, post-retirement benefits other than pension ("PBOP") and supply-related bad debt, may not need to be continued. Id. at 5, 13. This aspect of the Department's proposal does not follow from its decision to implement revenue decoupling to eliminate barriers to energy conservation.

Third, the Department's specific methodology for reconciling actual revenues to a revenue target is largely a workable and reasonable approach to the "reconciliation" aspect of revenue decoupling, with the exception that it accounts only for growth in the *number* of customers and does not account for growth *in usage* per customer typically experienced by companies in the past. Electric and gas companies have experienced growth in usage per customer in larger C&I customer classes and electric companies have typically experienced growth in usage per customer for residential and small C&I classes. The Department's straw proposal does not recognize or account for this dynamic, and therefore, falls short of the stated objective for the proceeding, which is to render gas and electric utilities neutral to changes in sales volumes. By ignoring a portion of the growth historically available to gas

and electric companies to offset increasing O&M costs and to fund system investment between rate cases, companies would be left worse off by implementation of the Department's revenue-decoupling mechanism. Therefore, for companies to be neutral to revenue decoupling, the Department will need to implement base ratemaking mechanisms that guard against revenue erosion between rate cases, which is currently mitigated by growth in usage per customer.

Each of these concerns is discussed in turn below.

A. Establishment of a Revenue Target

As implicitly recognized by the Department's straw proposal, the first step to be taken to institute a reconciling revenue-decoupling mechanism is the setting of a revenue target to which revenues may be reconciled. To that end, the Department's NOI "highlights" and envisions the need for completion of a base rate proceeding as a "prerequisite" for establishing a base revenue adjustment mechanism. Id. at 14. The Department states that base-rate proceedings are necessary in order to determine the level of revenues per customer in a way that meets the Department's statutory obligations and ratemaking precedent, and that to achieve this goal it is necessary for the Department to "understand the company's underlying distribution revenue requirement and allocation of the revenue requirement among customer classes through an allocated cost of service study." Id.

From a legal and policy perspective however, it is not necessary to re-calculate a company's underlying revenue requirement and allocation of that revenue requirement among rate classes to set a "just and reasonable" revenue target. Each company has rates in effect that have been determined by the Department to be just and reasonable and the Department has the authority and expertise to set revenue targets based on those rates. For

that reason, the Department's suggestion that it intends to conduct base-rate proceedings to review revenue requirements and cost allocations results from an interest in addressing policy objectives *other* than revenue decoupling (and the elimination of barriers to energy conservation), such as the desire to re-evaluate utility cost structures or to rearrange existing rate designs to create "efficient" price signals. Although these objectives are eminently reasonable and appropriate policy goals over the long term (and in a base-rate proceeding), there are countervailing policy goals that need to be considered in this proceeding, not the least of which is the utilities' ability to attract capital in an extremely uncertain regulatory environment where existing rate plans have been terminated or curtailed by regulatory fiat.

Nor does the implementation of revenue decoupling require the establishment of a new revenue requirement in order to identify a company's "allowed revenue requirement" or to ensure that a company's "decoupled" rates are just and reasonable under G.L. c. 164, § 94 from a practical perspective. All of the gas and electric companies operating in the Commonwealth are charging rates to customers that have been deemed "just and reasonable" by the Department. To implement a workable revenue-decoupling mechanism, it is only necessary to establish a revenue target designed to recover the "allowed revenue requirement" associated with existing rates. Annual ROE and earnings-sharing calculations can help to ensure that the revenue target is appropriately calculated to recover the allowed revenue requirement, and the Department has reasonably included this measure in its straw proposal.[1]

[1] For companies with existing rate plans, the Department should adhere to the earnings sharing mechanism established therein (and only to the extent provided for therein), rather than super-imposing the mechanism contained in the straw proposal. The earnings sharing parameters are an integral element of any long-term rate plan approved by the Department and cannot be disturbed without shifting the balance of considerations underlying the rate plan.

In that regard, the concept of setting a revenue target outside of a base rate proceeding (and consistent with the Department's statutory obligations) is not a new or difficult concept for the Department. In fact, the need to set revenue targets to collect approved revenue levels through just and reasonable rates underlies a broad range of ratemaking activities undertaken from time to time by the Department and the companies it regulates, including gas and electric rate unbundling, the implementation of conservation and load management plans, electric restructuring plans, annual PBR compliance filings and annual transition cost filings for electric companies.[2] In practice, any time that a company proposes that the Department approve a set of base-rate tariffs, it is requesting approval to recover the "allowed" amount of revenues that underlie those rates and from which the rates are derived. A company proposing to implement base-rate tariffs is required to provide the Department with "revenue proofs" and other analysis demonstrating that the rates will collect a certain revenue target, given the applicable billing determinants.[3] The Department approves the proposed base-rate tariffs for effect, only after its investigation shows the rates to be "just and reasonable," which reflects the implicit determination that the revenue "target" to be recovered through those rates is appropriate under G. L. c. 164, § 94.

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[2] See e.g., Boston Edison Company, D.P.U. 97-40 (1997); Cambridge Electric Light Company, D.P.U. 97-41 (1997); Commonwealth Electric Light Company, D.P.U. 97-42 (1997); Eastern Edison Company, D.P.U. 97-43 (1997); Fitchburg Gas & Electric Light Company, D.P.U. 97-44 (1997); Massachusetts Electric Company and Nantucket Electric Company, D.P.U. 97-45 (1997); Western Massachusetts Electric Company, D.P.U. 97-46 (1997); Cambridge Electric Light Company, Commonwealth Electric Company, and Canal Electric Company, D.P.U./D.T.E. 97-111 (1998); Western Massachusetts Electric Company, D.T.E. 97-120 (1998); Commonwealth Gas Company, D.T.E. 98-63 (1998); Colonial Gas Company, D.T.E. 98-64 (1998); Berkshire Gas Company, D.T.E. 98-65 (1998); North Attleboro Gas Company, D.T.E. 98-66 (1998); Boston Edison Company, Cambridge Electric Light Company, Commonwealth Electric Company, D.T.E. 99-19 (1999).

[3] Id.

Thus, from a ratemaking perspective, the process of calculating an appropriate revenue target under G. L. c. 164, § 94 (outside of a base rate proceeding), is standard practice for the Department and has been undertaken in a number of instances to accomplish industry-wide changes in public policy. There is simply no reason that the commencement of revenue decoupling would require a fully litigated base-rate proceeding, especially if the Department is monitoring annually reported rates of return. The evaluation of a utility's cost structure and the rate redesign that takes place in a base-rate proceeding is only necessary if the Department is attempting to address policy objectives beyond the implementation of revenue decoupling. If so, this effort to satisfy broader policy objectives will have the effect of complicating and significantly delaying the implementation of revenue decoupling and the associated disincentives for investments in energy efficiency, without any offsetting improvement in the efficacy of the revenue-decoupling mechanism.

This point is especially important in terms of implementing revenue decoupling without the forced termination of existing rate plans or the need for a base-rate proceeding. In that regard, it is not necessary for the Department to apply a "one size fits all" model that requires all utility ratemaking to return to "square one" before decoupling can be implemented and the barriers to aggressive promotion of conservation eliminated. In fact, proceeding with decoupling in the manner proposed by the Department (i.e., only through the conduct of future base rate proceedings) will be extremely disruptive, costly and time consuming, without any offsetting benefit in terms of achieving a greater level of "effectiveness" or accuracy in the revenue-decoupling mechanism. Companies that have long-term rate plans, like NSTAR Electric, have rates in effect that have recently been determined to be "just and reasonable" by the Department following an adjudicatory process.

Under these plans, an “allowed” revenue target would be discernible and reviewable, if presented by the company with supporting documentation. Therefore, allowing each company to implement the Department’s proposed annual reconciliation mechanism based on approved “target revenues” that are consistent with existing rate plans will avoid the potential for delay in implementation resulting from potential legal challenges to a decision to nullify existing rate plans, while ensuring that the Department has a valid basis upon which to commence revenue decoupling.

Notwithstanding other important considerations, the Department should take into account that financial markets rely heavily upon the integrity of the regulatory compact between regulators (acting on behalf of consumers) and regulated utilities (which are ultimately responsible to shareholders), to place a value on utility investment opportunities. The uncertainty that would be created from a market perspective were the Department to mandate base-rate cases for the entire utility industry in the Commonwealth, especially those with existing long-term rate plans, would likely be substantial and harmful to the interests of the companies and their customers in the final analysis. As demonstrated in the testimony of Mr. James Simpson, of Concentric Energy Advisors, *no jurisdiction in the country* has implemented decoupling by eradicating the existing ratemaking framework and resetting rates on a statewide basis. As a result, Massachusetts would be an obvious “outlier” in this respect, which, in the Company’s judgment, would invoke a strong negative reaction from financial markets leading directly to an increase in the cost of capital for Massachusetts utilities. The Department has long recognized that it is in the public interest to maintain adequate access to low-cost capital, and therefore, this objective is a fundamental component of the ratemaking process. Given that revenue decoupling can be implemented on an

expeditious basis without massive disruption to the investment environment, assumption of this risk is not a necessary or reasonable result for this proceeding. The Department's broader policy goals can and should be achieved over the long-term as companies seek base-rate relief at the Department in the normal course of business.

Accordingly, NSTAR Electric recommends that the Department allow each company to make a proposal to establish a revenue target consistent with its existing rate plan. Given that rate plans are put into effect based on the Department's finding that the rates resulting therefrom are just and reasonable, a decoupling mechanism that operates to collect the allowed revenue requirement under that plan would be consistent with G.L. c. 164, § 94. In addition, the Department would reserve the opportunity to pursue its broader policy goals regarding pricing efficiency for base-rate proceedings that will occur over time as rate plans expire.

B. Maintaining Adequate Cost Recovery

A second overarching concern raised by the Department's straw proposal is the suggestion that, once a base-rate proceeding is concluded and the revenue-decoupling mechanism is put in place, cost recovery mechanisms that currently work in conjunction with base rates to ensure recover of the allowed revenue requirement over time, such as PBR and reconciling charges for pension costs, post-retirement benefits other than pension ("PBOP") and supply-related bad debt, may not need to be continued. NOI at 5, 13. Like the Department's conclusion that revenue decoupling can only be implemented within the context of a base-rate proceeding, this aspect of the Department's proposal does not follow from its decision to implement revenue decoupling to eliminate barriers to energy conservation. This proposition arises from the Department's stated belief that the revenue

decoupling mechanism will "align company revenues with costs" and that by fixing the "allowed revenues by customer," a company's revenues will be more closely aligned with a "significant driver of costs on a company's system," which in the Department's estimation is the number of customers. Id. at 4, 11. The Department's assumptions in this regard should be reconsidered for several reasons.

First, the straw proposal outlined by the Department is based on the assumption that the decoupling mechanism will function to ensure the recovery of the "allowed" revenue requirement, with the revenue requirement remaining on par with a utility's costs over time because it would be adjusted each year for the number of customers. Although the Department is correct in its basic assumption that utilities will be neutral to changes in sales volumes between rate proceedings so long as utilities are able to collect a level of revenues equal to a utility's allowed "revenue requirement," the Department's further assumptions assuming a direct correlation between the number of customers and utility costs is unfounded. Specifically, the Department's assumption that a decoupling mechanism will ensure that a utility's revenues remain aligned with its costs, where the revenue target is founded on the historic test year cost-of-service and adjusted each year only for changes in the number of customers, is not valid given the realities of the utility cost structure. The Department has cited no basis for this assumption and the utilities' actual experience would not bear this out because O&M costs and construction and maintenance costs typically increase at a rate equal to or exceeding the rate of inflation. As a result, it is impossible for a utility to recover its "allowed revenue requirement" from year to year (including the allowed rate of return) without a cost-recovery mechanism (like PBR) that adjusts the level of

revenues commensurate with inflation and protects against revenue erosion associated with volatile costs outside the Company's control.

This proposition is supported by the Department's own historical experience with traditional cost-of-service regulation during the late 1980s and early 1990s and prior to the Department's adoption of PBR, supply-related bad debt reconciliation and other cost-recovery mechanisms that work to ensure that a company's revenues keep pace with its reasonable and prudently incurred costs without the need for frequent, costly and administratively burdensome base-rate proceedings. In fact, the frequency and magnitude of the base-rate requests brought to the Department by jurisdictional utilities prompted the Department to supplement its traditional cost-of-service ratemaking model with other cost-recovery mechanisms and ratemaking approaches, including PBR and merger-related rate plans. The Department's policy changes to implement PBR and other cost-recovery mechanisms has resulted in a situation where the majority of Massachusetts customers benefit from long-term price stability in relation to their distribution rates and also benefit from distribution rate levels that are substantially lower than otherwise would have occurred.

Aside from policies supporting mergers and the implementation of long-term rate freezes or other similar approaches, the primary ratemaking mechanism that the Department has adopted for this purpose is PBR. As conceived by the Department, the central concept underlying PBR is the principle that regulated firms will reduce costs over time where there is a financial incentive to do so; and where cost savings are achieved, customers are the ultimate beneficiaries because O&M cost reductions tend to have a permanent effect. Boston Gas Company, D.P.U. 96-50, at 304 (1996); NYNEX Price Cap Plan, D.P.U. 94-50, at 235 (1995). The Department has also recognized that the commencement of a long-term rate

plan will increase administrative efficiency and reduce costs for customers. D.P.U. 96-50, at 320; NYNEX at 271-2. Accordingly, the Department has repeatedly found that a well-designed PBR plan should be of sufficient duration to give the plan enough time to achieve its goals, and to provide utilities with the appropriate economic incentives and certainty to follow through with medium- and long-term strategic business decisions. D.P.U. 96-50, at 320; Incentive Regulation, D.P.U. 94-158 at 66 (1995); NYNEX at 272. In considering the applicability of PBR in this proceeding, it is significant that there is nothing about revenue decoupling that changes the basis for the Department's findings regarding the propriety of PBR as a ratemaking tool, and therefore, no basis for concluding that PBR (or PBR-like rate plans) are no longer needed or appropriate with revenue decoupling in place.

To that end, the underlying policy theory supporting the implementation of PBR is discussed in greater detail in the comments of Concentric Energy Advisors and Pacific Economic Group. However, the crux of this issue for the Department in this proceeding is that (1) the policy objectives motivating the Department's decision to adopt PBR remain important today, but are not addressed by the implementation of revenue decoupling; and (2) the elimination of PBR as a ratemaking tool will substantially diminish a company's ability to collect its allowed revenue requirement in the years succeeding a base-rate proceeding, leading to the need for more frequent base-rate proceedings. In fact, the Department's adoption of the PBR framework explicitly recognized that a utility's ability to recover its revenue requirement between rate cases will be impaired (even with access to sales growth), unless the utility has at least some opportunity and incentive to protect against revenue erosion that occurs as a result of inflationary pressures between base-rate proceedings.

Similarly, the Department has adopted reconciling factors for utility expense categories that (1) tend to be significant in terms of overall cost levels; (2) exhibit a high level of volatility; and (3) are not subject to the control of the utility. NSTAR Electric & Gas, D.T.E. 03-47-A, at 25-28, 36-37 (2003) (adopting a pension/PBOP reconciliation factor outside of base rates), Bay State Gas Company, D.T.E. 05-27, at 183-186 (2005) (confirming recovery of gas-cost related bad debt outside of base rates). The Department has found it appropriate to provide for recovery of these costs outside of base rates because it is difficult to capture a representative level of these costs for recovery through base rates and cost fluctuations that occur have a strong potential to negatively affect a company's ability to recover its allowed revenue requirement between base rate cases.

As with PBR, there is nothing about the introduction of revenue decoupling that changes or addresses the factors that originally motivated the Department to remove these types of costs from base rate recovery. Where actual costs deviate significantly from the "representative" cost level included in rates, the utility's ability to recover its allowed revenue requirement will be directly impaired. Thus, the implementation of a revenue decoupling mechanism that terminates cost recovery mechanisms such as the pension/PBOP reconciliation factor will make it substantially more likely that utilities are unable to recover the approved revenue requirement from the last base rate case. In any event, these reconciling factors are *already neutral* to changes in sales volumes because the mechanisms reconcile to actual costs regardless of fluctuations in sales volumes. Accordingly, there is no basis for the Department to change course in relation to these cost recovery mechanisms.

In the final analysis, recovery of a Company's allowed revenue requirement cannot and will not be accomplished through the implementation of the revenue decoupling

mechanism because it is designed to reconcile to a revenue target, not to ensure against revenue erosion that results from increasing costs between rate cases. A company's ability to recover its allowed revenue requirement is, and will continue to be, a function of the integrated cost-recovery mechanisms that are put in place by the Department to accomplish that objective. In that regard, the Department's proposal to reconcile revenues to historical cost levels and to terminate cost-recovery mechanisms that have been put in place to enable utilities to recover their approved revenue requirement over time despite these cost pressures, fundamentally attempts to turn the revenue decoupling mechanism into a cost-recovery mechanism. This approach will be ineffective because it is not adequately designed to capture the actual cost changes that utilities experience and that are addressed in reconciling cost-recovery mechanisms in place today.

Unless the Department adopts an approach that keeps adequate cost-recovery mechanisms in place, i.e., mechanisms that have been put in place to supplement the traditional cost-of-service ratemaking model using a historic test year, the Department will deploy a model that requires frequent base rate proceedings and discourages infrastructure investment for reliability purposes. Under the Department's proposal, Massachusetts utilities will come under significant pressure to reduce capital investment and cut O&M costs in order to recover their allowed return and remain neutral to the regulatory lag inherent in a ratemaking paradigm founded upon a historic test year. Consequently, the elimination of PBR and other cost-recovery mechanisms will inevitably lead to frequent, costly and burdensome rate cases; an increased level of uncertainty and financial risk and resulting impact on utility cost of capital, and increased potential for inadequate utility investment in light of the associated regulatory lag in adjusting rates. This outcome is wholly inconsistent

with current ratemaking practice across the country and is not necessary to implement a revenue-decoupling mechanism consistent with the Department's statutory obligations. Consequently, this outcome would represent a huge step backward for utility regulation in Massachusetts.

C. Accounting for Growth in Usage Per Customer

In this case, the Department's specific methodology for reconciling actual revenues to the revenue target is largely a workable and reasonable approach to the "reconciliation" aspect of revenue decoupling (and is represented in the second element of the straw proposal), with the exception that it accounts only for growth in the *number* of customers and does not account for growth *in usage* per customer. As noted above, both gas and electric companies have experienced growth in usage per customer in the larger C&I customer classes and electric companies have experienced growth in usage per customer in residential and small C&I classes. Like growth in customer load resulting from the addition of new customers, growth in usage per customer is beneficial to a distribution system between rate cases because it helps ensure that the Company will collect its allowed revenue requirement, by offering a means to partially offset O&M cost increases and to fund needed capital projects. Because the Department's proposed annual reconciliation methodology accounts only for growth in the *number* of customers, implementation of the Department's methodology will eliminate any potential for gas and electric companies to utilize the revenues associated with growth in usage per customer between rate cases. So long as the Department takes this factor into consideration in the ratemaking process going forward, the Department's proposal to implement its annual reconciliation methodology adjusting only for the number of customers would be workable.

Specifically, the testimony of Mr. John Reed and Mr. James Simpson of Concentric Energy Advisors outlines a number of ratemaking procedures that the Department should consider implementing in future base rate cases in conjunction with its revenue decoupling mechanism that would substitute for the loss of revenues associated with growth in usage per customer.

D. Recommendations

Based on the foregoing discussion, NSTAR makes the following recommendations:

→ Maintain Existing Cost-Recovery & Incentive Mechanisms: The Department should find that its proposed annual reconciliation mechanism may be implemented in conjunction with established cost recovery mechanisms, such as PBR or long-term rate plans, which have been found "just and reasonable" in prior ratemaking proceedings. The Department should also find that reconciling cost-recovery mechanisms should not be modified by revenue decoupling. These mechanisms apply to volatile costs, large in magnitude and beyond the control of the companies; and in addition, are already neutral to fluctuations in sales volumes.

→ Expeditious Implementation of Revenue Decoupling: The Department should require each electric and gas company to submit a company-specific proposal by a date certain to establish an appropriate revenue target so that revenue decoupling may be implemented on an expeditious basis. Depending on the distribution company's specific circumstances, the revenue target could result from a base-rate proceeding or from the Department's approval of a revenue target demonstrated to be consistent with a PBR or long-term rate plan currently in effect.

→ Revenue Neutral Implementation Consistent With Long-Term Rate Plans: To the extent that rate-design changes are necessary or desirable to implement revenue decoupling where a long-term rate plan is in place, the Department should allow companies to make a revenue-neutral proposal consistent with that rate plan.

→ Annual Reconciliation: Once a revenue target is set, the Department should implement its proposed annual reconciliation methodology to reconcile revenues to the established revenue target.

→ Monitoring Results: The Department should adopt its proposed annual earnings-sharing calculation to monitor and assess whether the approved revenue target and annual reconciliation mechanism are operating as planned. Earnings sharing provisions that are contained in currently effective long-term rate plans should be adhered to for the duration of those plans.

→ Future Ratemaking Proceedings: In base-rate proceedings to establish a revenue target or following the expiration of a long-term rate plan, the Department should review the distribution revenue requirement and allocation of the revenue requirement among customer classes through an allocated cost of service study, in order to achieve its policy goals of ensuring an efficient pricing structure. The Department should also consider new ratemaking approaches that provide for recovery of allowed revenues in the absence of growth in usage per customer, which has historically been available to the utility to offset costs and fund utility investment.

IV. Responses to Department's Questions

In its NOI, the Department set out 12 questions for specific comment. NSTAR's responses to those questions follow below:

> **DPU-1-1**: The Department's proposal that a company's allowed revenues per customer be determined through a subsequent base rate proceeding is intended to ensure that the allowed revenue levels, which serve as the basis for the base revenue adjustment mechanism are closely aligned with the company's costs. Under what, if any, circumstances should the Department permit a company's allowed revenues per customer to be determined through some manner other than a base rate proceeding?

From a legal, policy and practical perspective, it is not necessary to re-calculate a company's underlying revenue requirement and allocation of that revenue requirement among rate classes to set a "just and reasonable" revenue target. All of the gas and electric companies operating in the Commonwealth are charging rates to customers that have been deemed "just and reasonable" by the Department. The Department has the authority and expertise to set revenue targets using the rates that are currently in effect and determined by the Department in previous proceedings to be just and reasonable. Therefore, to implement a workable revenue-decoupling mechanism, it is only necessary to establish a revenue target designed to recover the "allowed revenue requirement" associated with existing rates. Annual ROE and earnings-sharing calculations will ensure that the revenue target is appropriately calculated to recover the allowed revenue requirement, and the Department has reasonably included this measure in its straw proposal.

Moreover, it is simply not necessary or desirable to terminate or curtail existing approved rate plans and embark on a very costly and time-consuming process of developing new rates and prices through litigated rate cases to establish a different level of target revenues. To embark on such an unnecessary process would result in an inordinate delay in promoting energy efficiency investments, which can be accomplished simply by implementing an annual revenue reconciliation mechanism. In addition, any uncertainty in the market concerning the future viability of any regulatory agreement would significantly add to the cost of capital to the detriment of customers and shareholders alike.

If it is the Department's broader objective is to establish a ratemaking paradigm that more closely aligns revenues with underlying costs, it could incorporate a forward looking formula in its base-rate ratemaking approach, similar to the methodology utilized by FERC in setting regional transmission rates. Under that model, the utility recovers its annual costs and allowed return on equity without any over or under recovery (and without any negative adjustment to the ROE penalty). The forward-looking test year is also employed by California in conjunction with its revenue decoupling mechanism. These ratemaking options enable companies to recover their allowed revenue requirement between rate cases despite inflationary pressures on O&M costs and construction and maintenance activities. Please see the discussion provided by Mr. John Reed and Mr. James Simpson of Concentric Energy Advisors in this proceeding.

> **DPU-1-2**: The Department's proposal uses an approach in which a company's allowed revenues per customer for each rate class does not change between base rate proceedings. An alternative approach would be to adjust the allowed revenues per customer values periodically, based on changes in each rate class' average usage per customer. Please discuss the merits of each approach.

The Department's straw proposal to fix the "allowed revenues per customer" between rate cases and to potentially eliminate PBR, long-term rate plans and other reconciling cost-

recovery mechanisms is not a viable policy because of the cost increases that occur from year-to-year as a result of inflation and ever-increasing system replacement and improvement costs. Therefore, if a decoupling mechanism is put in place that does not provide for recovery of volatile costs outside the utility's control, PBR or PBR-like rate components, utilities will experience revenue erosion between rate cases as a result of O&M inflationary pressures and capital funding requirements, which will not be addressed by the decoupling mechanism and that will drive the need for frequent rate cases. If implemented in conjunction with existing long-term rate plans, PBR and other cost-recovery mechanisms, the concept of "allowed revenues per customer" is probably workable so long as the Department takes into consideration that growth in usage per customer is not addressed in the Department's model.

Moreover, changes in usage pattern between classes can result in significant price dislocations if the revenues per rate class are fixed. For example, if a large customer becomes a co-generation customer due to the installation of a combined heat and power generator (CHP), the impact on the remaining class members may take the form of unacceptable price shifts. Under these circumstances a revenue-neutral rate redesign between customers would help to avoid rate shock and would ensure that the societal benefits associated with CHP would flow to all customers along with cost recovery.

> **DPU-1-3:** The Department's proposal that a company's actual versus allowed revenues be reconciled annually is intended to balance three objectives: rate stability, rate continuity, and administrative efficiency. Do annual reconciliations strike an appropriate balance among these three objectives or would alternate reconciliation periods (e.g., quarterly or semi-annually better do so?

Annual reconciliation will, in all but the most volatile of circumstances, strike the appropriate balance among rate stability, rate continuity and administrative efficiency. Rate

continuity is another form of price stability for customers. In that regard, customer surveys have shown that customers appreciate stable rates and in many cases would prefer a fixed charge for their electric and gas service. Thus, the objective of rate stability is important and holding rates constant for a longer period is a valid objective dictating a preference for an annual rate rather than a quarterly or semi annual rate. On the other hand, a reconciliation that takes place before large over or under recoveries occur will avoid abrupt rate changes for customers. The more often rates are reset, the less likely that a rate discontinuity occurs. The best way to handle potential discontinuities is to set a level of deferrals that trigger the reset of rates, similar to the approach previously used for electric fuel clause and currently used for gas fuel clause filings to great effect. Because the annual accounting period includes audited financials, proper review by the Department is facilitated by timing the review with the annual accounting period.

Therefore, the Department should establish a process to monitor the under or over-recovery so that an interim adjustment could be made to smooth the rate impact and avoid rate continuity issues. To that end, the Department should set a threshold level of deferrals that would trigger an interim adjustment should the threshold be exceeded (either an over or under-recovery).

> **DPU-1-4**: The Department's proposal to determine a company's actual revenue based on billed revenues is consistent with the base rate treatment applied to distribution-related bad debt costs. An alternative approach would be to determine actual revenues based on payments received. Please discuss the merits of each approach.

In a base-rate proceeding, the Department's policy is to include an allowance for bad debt in the cost-of-service and resulting revenue requirement. Thus, the "allowed revenues" inherently anticipate the recovery of "uncollectible" revenues. If the Department were to

include bad-debt expense in base rates and then also to implement a decoupling mechanism that reconciles actual receipts (rather than billed receipts) to target revenues based on those rates, bad-debt expense would be double counted. Therefore, the approach taken in the Department's straw proposal to determine actual revenues based on billed revenues is appropriate.

> **DPU-1-5:** The Department's proposal for determining billed revenues is based on actual consumption. An alternate approach would be to determine billed revenues based on consumption normalized for weather and/or other factors.
>
> (a) Please discuss the merits of determining billed revenues using actual versus weather-normalized consumption.
>
> (b) Should consumption be normalized for other factors (e.g., economic conditions)? If so, identify those factors and describe how the normalization for such factors could be done.

If the reconciliation uses billed revenues, rather than weather-adjusted revenues, it will better achieve the Department's goals of rate stability, rate continuity, and administrative efficiency. For example in a warm summer, the unadjusted usage would mean a reduction in price for customers, mitigating high summer bills. This mitigation also helps the Department's goal of continuity. Lastly, the reduction in administrative costs associated with the elimination of the review and investigation of the optimal methods of weather adjustment, are savings that accrue to customers in the longer term.

Whereas weather is a short term factor that affects sales, there are other factors such as the economy, new technologies, and conservation that also affect sales. Short term rate stability and rate continuity are not significant factors here as the impacts are longer term and the volatility is not as significant as weather. Lastly, the administrative costs involved in determining the impacts of factors on each customer group would be significant since experts

would need to be involved. Instead, the Department can easily monitor the balance of revenues and costs through its annual earnings sharing review.

> **DPU-1-6**: the Department's proposal to recover the difference between a company's target and projected revenues through adjustments to its base energy charges is intended to send appropriate price signals to consumers. An alternate approach would be to adjust both base energy and demand charges (where applicable) to recover this difference. Please discuss the merits of each approach.

For some rate classes, there is very little distribution revenue recovered from the energy charge portion of the rate. Most of the base rate revenue comes from the demand charge. Therefore, it would be necessary to adjust both the energy charge and demand charge using the same percentage. Another alternative would be to reset customer, energy and demand charges to redesign rates annually to reach the allowed revenue requirement. This annual revenue-neutral rate-design protocol would allow the pricing objectives, ranging from demand impacts from price response such as summer surcharges or customer interests in flat customer charges, to be proposed and reviewed by the Department.

> **DPU-1-7:** The Department's proposal to require a company to submit quarterly filings identifying actual and allowed revenues is intended to ensure that changes in rates are made in a predictable and gradual manner.
>
> (a) Under what circumstances should the Department allow an adjustment in base charges during a reconciliation period?
>
> (b) Under what circumstances should the Department initiate a review of a company's base revenue adjustment mechanism?

Please see the response to DPU-1-3. The Department should provide for an annual reconciliation and adjustment in base charges, subject to an appropriate threshold that would trigger an interim change should a material under- or over-recovery occur during a reconciliation period. The Department may find it necessary to review the operation of a company's base revenue adjustment mechanism if (1) repeated and significant under or over-

recoveries are occurring; or (2) a company's ROE indicates that something is out of line. In practice, it is unlikely that there will be a need to "review" the base revenue adjustment mechanism once it is designed and implemented because it should operate fairly transparently.

> **DPU-1-8**: What standards should the Department use to measure the performance of a company's base revenue adjustment mechanism over time?

In terms of measuring the "performance" of a company's base-revenue adjustment mechanism, the Department should consider whether:

- There is no positive or negative incentive for the utility to maintain or increase sales;
- There is an ability to recover the "allowed revenue requirement," without a the need for repeated and frequent base rate cases;
- There is an opportunity to earn a fair return; and
- There is an incentive to maintain the investment level necessary to ensure safety, reliability and efficiency of the distribution system.

In practice, the Department's proposal to require annual earning sharing calculations will ensure that a company is not unacceptably under-earning or over-earning and that the utility is able to recover its allowed revenue requirement without consideration of sales volumes.

> **DPU-1-9**: How will the implementation of a base revenue adjustment mechanism affect a company's risk and how should such considerations be reflected in a company's capital structure and ROE?

Please see the testimony of Mr. John Reed of Concentric Energy Advisors**.** As discussed in Mr. Reed's testimony, the market values utilities primarily on the basis of future earnings expectations. Therefore, an important factor for investors is whether the utility has the probability of achieving its allowed ROE in the future. Since costs increase annually, a plan that sets allowed revenues per customer on a historical basis (and that removes load

growth as an option for mitigating cost increases) is likely to raise substantial concerns regarding the ability to achieve allowed ROEs on a consistent basis.

It should also be noted that any new overarching regulatory scheme, such as revenue decoupling, presents new and unforeseen risks to the financial market. A prime example is the decoupling plan put into effect in Maine in which recovery was deferred for several years. As a result, the amount became politically unacceptable to recover leading to a significant cost to the utility shareholders.

> **DPU-1-10**: The Department's proposal to include a shared earnings provision in the base revenue adjustment mechanism is intended to strike an appropriate balance between the risks borne by customers and shareholders associated with company earnings. Please comment on the merits of such a provision. Also comment on the design of the proposed earnings sharing provision.

The Department's proposal to include a shared earnings provision would allow for monitoring and evaluation of the decoupling mechanism and would enable the Department to implement decoupling with existing rate plans in place. However, the Department should adhere to the structure and scope of any earnings sharing mechanism included in a company's long-term rate plan because it represents an integrated element of an overall plan, which is the result of a balancing of considerations underlying the rate plan. Therefore, the Department should not disturb or replace the earnings sharing mechanisms encompassed in existing rate plans.

> **DPU-1-11**: Please comment on the merits of implementing a base rate adjustment mechanism with and without the individual elements of a PBR plan (e.g., fixed term, inflation, productivity, performance standards, exogenous factors.

Please see the discussion set forth above in Section II. A base rate adjustment mechanism is appropriate to adjust declines in sales as a result of conservation or other impacts. Cost inflation is a dynamic that is totally separate and apart from the objectives

served by revenue decoupling. PBR is intended, in part, to address this dynamic, while providing consumers with productivity benefits inherent in a rate adjustment that increases rates to a level that is lower than the expected increase in costs. To the extent that the utility can contain costs to a level below the allowed level, shareholders as well as customers will benefit. The inclusion of exogenous costs in a PBR mechanism is necessary to avoid significant costs or gains that arise from unexpected external or exogenous events and that would substantially erode a company's ability to recover its allowed revenue requirement.

The Department's base-revenue adjustment mechanism is appropriate to adjust for declining consumption and to ensure that utilities have no incentive to maintain or increase sales. However, the Department's proposed mechanism is not sufficient, if applied in isolation of approved cost-recovery mechanisms, to ensure that utilities will be able to recover their revenue requirement between rate cases. In particular, PBR is designed to provide the utility with incentives to control costs and provides the utility with the ability to share in the benefits of long-term investments that achieve this goal, but require substantial investment by the utility. In addition, the pension/PBOP reconciliation factor allows for recovery of pension and PBOP expense outside of base rates so that the Company is able to recover its allowed revenue requirement without impairment by an expense category that has the potential to be large, volatile and outside of the control of the Company. Moreover, the Department's NOI indicates that the Department intends to maintain its service quality performance requirements, which was designed to work in coordination with a PBR plan that would provide the utility with the incentive to make service quality investments. Lastly, when utilities have an incentive to work over a long-term rate plan to achieve cost savings, those cost savings become permanent components of the utility's cost structure to the benefit

of customers. For all these reasons, the Department should implement decoupling along with PBR and other cost recovery mechanisms adopted by the Department in the past 15 years to meet public policy goals apart from the desire to promote conservation.

> **DPU-1-12**: Please comment on how the Department should schedule the implementation of a base revenue adjustment mechanism for each gas and electric company in light of the need to move expeditiously, the resources required to implement such changes, and the specific circumstances of each company. How should the Department determine the order of individual base rate proceedings?

As discussed above, the Department should require each company to propose a revenue target by a date certain that is consistent with existing rates and/or rate plans already determined by the Department to be just and reasonable. Because proceedings to establish revenue targets would not be as time-consuming as a series of fully litigated base-rate cases, the Department would be in a better position to review those proposals and implement revenue decoupling on an expeditious basis. Some companies may elect to petition the Department for base-rate changes and those cases could be addressed by the Department as filed. Therefore, a procedural schedule to set revenue targets would only have to include those companies not electing to commence a base-rate proceeding.