

PUBLIC UTILITIES COMMISSION

IN RE: PROVIDENCE GAS COMPANY - PRICE STABILIZATION PLAN DOCKET NO. 2581

REPORT AND ORDER

INTRODUCTION

On June 9, 1997, the Providence Gas Company (hereafter the "Company") filed a Petition with the Rhode Island Public Utilities Commission (hereafter the "Commission") that it open a docket for the development and investigation of a price stabilization plan for the Company as an alternative to a general rate filing. The Company requested in the Petition that the docket be opened "to provide a forum and to give notice to interested parties to provide the broadest opportunity for all interested parties to participate from the outset of the settlement process." On June 10, 1997, the Commission approved the opening of this docket.

RATE HISTORY

The Company's recent rate history is as follows:

Year Filed.....	Docket No.....	Amount Requested.....	Amount Granted
1988.....	1914.....	\$8,309,932.....	\$4,860,000
1990.....	1971.....	\$15,837,686.....	\$9,176,000
1993.....	2082.....	\$11,429,611.....	\$ 694,000
1995.....	2286.....	\$14,879,708.....	\$3,990,000

The Company also filed in November of 1995 a rate design proposal which resulted in the approval of a Settlement Agreement and new tariffs in May of 1996. Re: Providence Gas Company Rate Design Filing, Docket No. 2374 (1996). Among the provisions of that Settlement Agreement were unbundled services and the requirement that further unbundling be addressed in the future. To that end on April 2, 1997 the Company made its Phase II Unbundling filing. That filing resulted in the approval of a Settlement Agreement on September 1, 1997. Re: Providence Gas Company Phase II Unbundling, Docket No. 2552 (1997).

Once this docket was opened by the Commission the Energy Council of Rhode Island (hereafter "TEC-RI") and the George Wiley Center (hereafter "Wiley") moved to intervene. Those petitions to intervene were granted and the following appearances were entered in this proceeding for the intervening and other parties:

FOR THE COMPANY: Dennis Duffy, Esq., Partridge, Snow & Hahn and Alysia L. Goody, Esq., Providence Gas Company

FOR THE DIVISION OF PUBLIC UTILITIES AND CARRIERS: Paul Roberti, Esq., Special Assistant Attorney General

FOR THE ENERGY COUNCIL OF RHODE ISLAND: Andrew Newman, Esq., Rubin & Rudman

FOR THE GEORGE WILEY CENTER: Hugo Ricci, Jr., Esq.

FOR THE COMMISSION: Thomas W. Heald, Esq.

TRAVEL OF THE CASE

Upon the opening of this docket the Company entered into extensive discussions and negotiations with the Division of Public Utilities and Carriers (hereafter "Division"), TEC-RI and Wiley. On August 12, 1997, the Company filed with the Commission a proposed Settlement Agreement which had been executed by the Company, Division, TEC-RI and Wiley. Joint Exhibit #1 (hereafter "Jt. Exh. #1"). In the cover letter that accompanied the Settlement Agreement, the Company noted that the Agreement called for the implementation of a price stabilization plan which included:

(1) an immediate decrease in the Gas Charge to residential, commercial and industrial sales service customers; (2) a three-year freeze in the Gas Charge and base rates at those reduced levels; and (3) the Company's commitment to substantial incremental capital investments and further unbundling of services.

Commission approval of the Settlement Agreement was requested. The prefiled testimony of James DeMetro, Senior Vice President of Energy Services and Timothy S. Lyons, Assistant Vice President for Pricing and Regulatory were submitted in support of the Settlement Agreement. Company Exhibit #1 and #2 (hereafter "Co. Exh. #1 and #2"). The Settlement Agreement contained the following provision:

In the event that changes in market conditions prior to the Commission decision result in unacceptable changes to the economic benefits of this Settlement Agreement to any party hereto, then this Agreement shall be deemed withdrawn and shall be null and void in all respects.

Jt. Exh. #1, p. 14.

AUGUST 14, 1997 HEARING

Having been advised by the parties that prompt action on the request for approval of the Settlement Agreement was important to its viability, the Commission scheduled a hearing for August 14, 1997 at 10:00 a.m.

The Commission began the hearing by taking comments from the public. Mr. Joseph Corcoran of 20 Thatcher Street, Rumford, Rhode Island was duly sworn. He questioned whether there was any regulation of the gas that comes into Rhode Island from Texas or the Southwest - was there a regulatory body that regulates the profits that those gas suppliers make? He was advised of the role of the Federal Energy Regulation Commission (FERC) and was directed to contact it about the wholesale regulation of gas. Transcript August 14, 1997, Pages 4-7 (hereafter " T. 8/14/97 pp. 4-7").

Mr. DeMetro then discussed the major issues facing the Company and how the proposed Settlement Agreement would address those issues. His discussion was supported by a descriptive handout. Co. Exh. #3. Mr. DeMetro noted that the volatility of natural gas prices was one of the key targets of the agreement. He stated that the volatility was caused by two things -- the fact that natural gas "is the most volatile commodity traded on the New York Mercantile Exchange" and the Company's Gas Charge Clause ("GCC") mechanism which "exaggerates" the "swings" in the market. T. 8/14/97, p. 15. Mr. DeMetro testified that the GCC mechanism was "developed during a time when well-head prices were heavily regulated by the Federal Government", and that when those prices became deregulated the mechanism did

not always respond appropriately to the market's daily price swings. T. 8/14/97, p. 16.

System utilization was also identified by Mr. DeMetro as an important issue to be addressed by the Agreement. He noted that the Company's distribution system and gas supply resources are now heavily oriented toward residential heating customers. He stated that both of those components must be utilized at a higher level so that fixed costs to the Company's customers can be reduced. T. 8/14/97, p. 16.

Mr. DeMetro identified economic development as another major area of concern. He indicated that most of the development in the State is in the southern area, especially around Quonset Point and in the northwest area. He stated that the Company's present system in those areas is "capacity constrained" and unable to support the economic development in those locations. T. 8/14/97, p. 17. He asserted that the Company needed to look at how it will support that development.

The maintenance of a safe and reliable system was another issue that Mr. DeMetro identified. He stated that in 1997 the Providence Gas Company was 150 years old and that many of its pipes "are almost that old". Thus, there is a need to step up the program of replacing those pipes and update the service records of the company to provide better access and more information. T. 8/14/97, pp. 17, 18.

Social needs must also be addressed by the Agreement. In particular, Mr. DeMetro acknowledged the importance of continuing the low income weatherization program and the low income heating assistance program. T. 8/14/97, p. 21.

Lastly, Mr. DeMetro spoke of the need to recognize and deal with the introduction of competition into the gas utility industry. In particular, he noted the need to continue and expand the Company's unbundling initiatives. T. 8/14/97, p. 18.

Mr. DeMetro then went on to describe how the Settlement Agreement addressed these "critical issues." He stated that the Settlement Agreement represented a "solution that integrated all these various issues in a comprehensive way". T. 8/14/97, p. 19. He asserted that it was the Company's opinion that the Settlement Agreement, or price stabilization plan, provided "a lot of benefits to customers as well as to the Company and as well as to the state overall". T. 8/14/97, p. 20.

Mr. Lyons then went on to describe the details of the price stabilization plan and how it specifically dealt with the critical issues outlined by Mr. DeMetro. Perhaps the most important element of the plan identified by Mr. Lyons was the proposed \$52 million price decrease and freeze for three years. The Company proposed to achieve that decrease and freeze by buying all of its gas supply requirements from one source for the three-year period. That \$52 million reduction would translate into about a \$1.00 per mcf reduction or an annual savings of \$110 per year for the average residential heating customer. T. 8/14/97, p. 29. The freeze was to be in effect from October 1, 1997 through September 20, 2000. Accordingly to Mr. Lyons, it was a freeze on all rates: "[i]t would apply to the GCC rates as well as to the base rates, base rates being all the customer demand and commodity charges would be frozen." T. 8/14/97, p.31.

Mr. Lyons described the \$52 million reduction as being the product of two things:

It's a net impact of an increase in the through put factor and a decrease in the GCC factor and the reason for that is because . . . , all the infrastructure related investments that will be going on over the next three years, we wanted to ensure for equity purposes that not only the sales customers but also the transportation customers would be paying for those investments. So the through put increase basically meets that objective of ensuring that for equity purposes both sets of customers would pay for those. And then the GCC decrease would be eligible for the sales service customers.

T. 8/14/97 pp. 28,29.

With respect to the infrastructure related investments, Mr. Lyons noted that by the terms of the Settlement Agreement the Company was committed to make "capital investments that will promote economic development in Rhode Island and enhance the safety, reliability, and integrity of the distribution system". Jt. Exh. #1. p. 5. Specifically, the stabilization plan calls for the following investments:

1. Economic Development

- a. . . .construct a high pressure main into and within the Quonset Point - Davisville Development.
- b. . . .construct a high pressure main south of the Tennessee Gate Station,. . . .

2. System Integrity

- a. . . .accelerate the replacement of cast iron and bare steel mains and services (to). . . an average of approximately 10 miles per year. The Company shall replace no less than 8 miles per year and no less than 30 miles during the Term of the Agreement.
- b. . . .review, update and consolidate substantial portions of its mains and services records, replacing a basically paper file system having records dating as far back as 1874. The Company shall review, update and consolidate on a best efforts basis no less than 12%, 43% and 75%, cumulatively, of its records during FY98, FY99 and FY00, respectively....

3. Economic Development and System Integrity

- a. . . .construct a gate station and associated main in the Northwest section of the service territory.

Jt. Exh. #1, pp.5-7.

Mr. Lyons also discussed the Integrated Resource Plan (IRP) commitments contained in the Settlement Agreement, which consist of the Low Income Assistance Program (LIAP), Demand Side Management (DSM) and the Low Income Weatherization Program. Jt. Exh. #1, p.7. With regard to the DSM and Low Income Weatherization programs, he noted that under the Company's IRP docket, Docket No. 2025, those two programs would be scheduled to expire in June of 1998. However, under the Settlement Agreement in this docket, they would continue for the term of the Agreement (until September 30, 2000). T. 8/14/97, p. 37. The Settlement Agreement called for an increase in the funding for the LIAP from \$800,000 to \$1.0 million per year. The DSM and Low Income Weatherization programs would continue to be funded at an annual levels of \$0.5 million and \$0.2 million, respectively. Jt. Exh. #1, p. 7. The Settlement Agreement provides that "[u]nused funds for these programs at the end of the first and second Term Years shall be added to the funds available for the second and third Term Years, respectively." Id. Any unused funds at the end of the third Term Year shall, in the case of the DSM program, be added to the Deferred Revenue Account (which will be discussed below) and in the case of the two low income programs "shall be utilized to assist low income customers in a manner agreed to by the Settling Parties and subject to approval by the Commission." Jt. Exh. #1, p. 7.

With regard to the unbundling commitments contained in the Settlement Agreement, Mr. Lyons indicated that it called for continuing "the process that we've started." T. 8/14/97, p. 38. Specifically, the Settlement Agreement provides:

[F]or additional staffing and technology resources as necessary to implement the unbundled service offerings in connection with its filing in Docket No. 2552. The Company shall provide unbundled service offerings to up to 10% per year of firm system throughput for Medium, Large and Extra Large C&I customers in FY98, as well as residential and small C&I customers in FY99 or FY00.

Jt. Exh. #1, p. 8.

Mr. Lyons explained that the unbundling limitations were necessary to provide the price freeze:

If we didn't at least put some parameters around how much unbundling, that would just create so much uncertainty in terms of the hedging cost that it would increase the costs associated with hedging. And what we were trying to do is

come up with a more balanced approach in terms of providing customers with an opportunity for the unbundled services on the one hand, but at the same time not making hedging costs tremendously high at the same time. So we had established a limitation associated with that.

T. 8/14/97, p. 39.

Lastly, Mr. Lyons addressed the financial commitments of the Settlement Agreement which include certain accounting treatments, quarterly reports and financial performance limitations. The accounting treatments include a write-off of \$3.1 million of environmental costs which largely relate to a site investigation and clean up that was conducted at the Company's Allens Avenue facility. T. 8/14/97, p. 39. The other component of the accounting treatments is the amortization over a five year period of any ongoing environmental costs that the Company has incurred as well as costs related to the year 2000. T. 8/14/97, p. 40; Jt. Exh. #1, p. 8.

One key component of the Settlement Agreement is the reporting requirement. During the term of the Agreement, the Company is to provide quarterly reports to the Commission and settling parties which are based on audited financial statements adjusted to comply with the Commission's most recent rate order and which are to include information on Return on Equity ("ROE") measurement; operating revenues and expenses; capitalization; and calendar degree days. Jt. Exh. #1, p. 8.

There are four financial performance limitations. First, there is an earnings or ROE cap of 10.9 percent which was the level approval by the Commission in the Company's most recent rate decision, Docket No. 2286. Re: Providence Gas Company, Docket No. 2286 (1995) p. 22. Secondly, there is an ROE floor of 7.0 percent. The third limitation is a moving cap on the average of beginning and ending equity used to calculate the Company's average return on common equity. The Settlement Agreement provides that "such average of common equity (shall)...not exceed \$81.0 million in FY98, \$86.2 million in FY99, or \$92.0 million in FY00." Jt. Exh. #1, p. 9.

Lastly, there is a limitation on operations and maintenance (O&M) expenses. The Settlement Agreement provides as follows:

To calculate annual O&M expense limitations for each Term Year, the Company shall utilize actual non-gas O&M expenses, in accordance with the FERC Form No. 2; provided that such O&M expenses do not exceed an annual threshold based on eighty-five percent (85%) of the annual Term Year increase in the simple average of Consumer Price Index (CPI) and Gross Domestic Product - Producer Index (GDP-PI) compounded from the FY96 base of \$46.5 million.

Jt. Exh. #1, p. 9.

This section of the Settlement Agreement also provides for the calculation of "ROE utilizing actual non-gas O&M expenses" where "unforeseen exogenous events which are beyond the Company's reasonable control" cause the Company to exceed the annual threshold. Jt. Exh. #1, p. 9. Examples of such exogenous events are set forth in the Agreement. Any disputes relative to this section are to be resolved by the Commission.

To maintain the fixed price over the three-year period, the Settlement Agreement calls for the establishment of a Deferred Revenue Account (DRA). Jt. Exh. #1, p. 10. At the end of the first year of the plan:

[A]ny earnings for such year in excess of an ROE of 10.9% shall be credited on a pre-tax basis to the DRA and for any deficiency in earnings for such year below an ROE of 7.0% shall be debited against the DRA through the deferral of costs. Further, any variance in the actual GCC deferred balance on September 30, 1997 from the projected GCC deferred balance included in the compliance filing will be credited to or debited against the Deferred Revenue Account. Any resulting positive or negative balance of the DRA shall be carried forward to the second Term Year.

Jt. Exh. #1, pp. 10, 11.

There are similar provisions for credits and debits in the second and third years for excess earnings or earnings deficiencies. At the end of the third year, the Settlement Agreement calls for the refund of any positive DRA balance to the firm customers and a surcharge to customers for any negative DRA balance:

Any resulting positive DRA balance at the end of the third Term Year shall then be refunded to the firm customers, and any resulting negative DRA balance at the close of the Term shall be recovered by the Company through a surcharge to customers over a reasonable period. In either case, the method of addressing any DRA balance at the conclusion of the third Term Year shall be determined by the Settling Parties and approved by the Commission.

Jt. Exh. #1, pp. 12, 13.

Mr. Lyons described the important role of the DRA to the success of the stabilization plan as follows:

And the reason that that mechanism makes sense is because there's really a mismatch between how the annual revenues are generated under the agreement and what the expenses are under the agreement and the costs of really funding a lot of these commitments. Those are going to be increasing over the term of the agreement with more and more infrastructure investment and the commodity investments will be decreasing, so the deferred revenue account basically establishes, really enables a lot of the smoothing in terms of the prices. And I think it really is the engine behind the price stabilization plan in terms of the planning horizon.

T. 8/14/97, pp. 41, 42.

There is an Exogenous Changes clause in the DRA section of the Agreement. It defines Exogenous Changes as "significant increases or decreases in the Company's costs or revenues which are beyond the Company's reasonable control." Jt. Exh. #1, p. 13.

At the conclusion of the Company's presentation, the Division's consultants testified about their involvement with and approval of the Settlement Agreement. Those consultants were Mr. Bruce R. Oliver, President of Revilo Hill Associates, Inc., an economic consulting firm which specializes in the analysis of utility rate and regulatory policy issues and Mr. Richard W. LeLash, a principal of Georgetown Consulting Group, Inc., a financial consulting firm specializing in utility regulation. These gentlemen have had prior involvement with the Company. For example, in the Company's recent rate design filing they were witnesses on behalf of the Division. Re: Providence Gas Company Rate Design Filing, Docket No. 2374 (1996).

Mr. Oliver described the Division's participation in this matter and resulting Settlement Agreement as follows:

The Division's review of the Providence Gas Company price stabilization plan has placed particular emphasis on ratepayer protection. The Division has endeavored to ensure consistency with the Commission's determinations in the company's last base rate case, Docket No. 2286. The Division has undertaken a detailed review of forecasted revenues, expenses, plant investments and capital requirements as part of a due diligence activity on our part and worked in a very intense way over the last couple months with the company to reach this settlement....

[W]e have had extensive interaction with the company, company personnel relating to price stabilization issues. We've performed substantial discovery, both formal and informal, and had responses from the company to a large number of requests for information. We have had numerous conference calls, face-to-face meetings, draft settlements, settlement proposals, counter-proposals, and a lot of back and forth resulting in what you see before you today. The results of the process reflect the Division's efforts to ensure protection of ratepayer interests....

T. 8/14/97, pp. 44, 45.

Mr. Oliver went on to outline the ratepayer protections: "a hard cap on the Company's return at the 10.9 percent ROE level"; "parameters . . . to ensure that it would be an effective cap" which include "limits on increases in the Company's O&M costs" and "limits on the amount of equity that the company can reflect in its calculations of ROE." He also noted the "agreement on accounting methods," in particular the "zero deferred gas cost balance at the end of the three-year period." He described the "mechanism to pass back to ratepayers any net overearnings" as "an important consideration" as the Division believed "with the investment that the Company is being provided, . . . there should be opportunities for increased sales growth." He asserted "that ratepayers' interests are also represented . . . through agreements to continue the unbundling, . . . DSM programs and to expand low income programs." Mr. Oliver likewise noted the "protections to the company to ensure that the company and as a result ratepayers are not adversely impacted by unpredictable, large, exogenous events." He identified the stabilization of gas costs as "a very important step" as the "GCC mechanism . . . has not been working to satisfaction." T. 8/14/97, pp. 45-49.

Mr. Oliver expressed the view that the Settlement Agreement "provides for a reduction of regulatory activity without a reduction of regulatory oversight." T. 8/14/97, p. 50. In support of that contention, he made reference to the requirement of filing quarterly reports. Lastly, he stated that he believed the Agreement would "foster competition" and furthermore, "mitigate...the potential need for further increases in rates at the end of the price stabilization period." T. 8/14/97, pp. 50, 51.

Mr. LeLash also testified in support of the Settlement Agreement. His testimony focused in large part on the gas price stabilization aspects of the plan:

First let me say that other jurisdictions, other companies have come forward with price stabilization plans in the gas industry...The more current trend is toward fixed price programs. I would say 25 or 30 utilities that I am aware of right now are moving away from what you call the GCC clause to a lock-in price portfolio. And to be very candid with you, the reason for this is that hedging experienced to date has not been good for the LDCs that have been doing it.

T. 8/14/97, pp. 52, 53.

He emphasized the importance prompt Commission action:

In that regard, you heard mention earlier about a window of opportunity and I want to show you a little bit about that window...And the reason we talk about a window of opportunity, as we saw the sensitivity to the deal, this is an out source gas supply. A major U.S. national supplier is essentially going to provide a fixed price element of it. That supplier is going to do the hedging. The company is not. The supplier is going to. They will. . . lock it in based on the price. What we are saying to you very importantly is let us lock it in here, get this program in quickly. . . . But the timing, as we get closer and closer to the winter season, becomes more and more critical. The opportunity times in the past have shown up to be in August, August and early September, not in October, November, December.

T. 8/14/97, pp. 54, 55.

Lastly, Mr. LeLash reiterated the benefits of the price stabilization plan and encouraged its approval by the Commission.

This plan I think -- I don't think, I know, has three benefits above them. It's a shorter term plan than typical AFR, alternative form of regulation or alternative regulation plan, it has better controls and it has more committed benefits; there are tangible benefits for infrastructure; there are better controls with the hard equity cap....

The staff, the Division rather certainly recommends quickly that a decision be made on this. We specifically say that we recommend its adoption. I've seen a lot of plans. This is a good one; it was well thought out. The company was responsive to criticisms and made changes and I think just the variety of people signing onto this program is an awfully good indication that there is something in this for everyone and that it will benefit both the state and the ratepayers.

Mr. Ricci, on behalf of The George Wiley Center, stated that his client was "satisfied with the proposal" and that it urged "the Commission to adopt it." T. 8/14/97, p. 159.

At the conclusion of the hearing, the Commission took the matter under advisement.

AUGUST 28, 1997 HEARING

After being advised by the Company that the gas supplier which it had contemplated contracting with on August 14, 1997 had withdrawn its participation and that the Company was negotiating with another supplier the Commission scheduled a hearing in this matter for August 28, 1997 at 11:00 AM to review and possibly act upon any subsequent filings made by the Company. In fact at 10:25 AM on August 28, 1997 the Company filed an Amendment to Settlement Agreement with the Commission Clerk. Jt. Exh. #2. Thus, the Commission proceeded with a hearing on that date at 11:00 AM.

At the August 28, 1997 hearing, Dennis J. Duffy, counsel for the Company advised the Commission of the status of the negotiations with the new supplier and the time restraints associated with those negotiations:

The Company and all the parties involved are working under a situation which I think unfortunately led to some confusion where we were able to come to terms with a supplier as well as all the parties only after 3:00 p.m. yesterday afternoon and the terms of that deal made the most sense and the best price, the parties felt was reached under a scenario which only had the supplier obligated through today's trading activities which unfortunately brings us back to just 2:00 p.m. today. . . .

Really our only point was the pricing provisions of the supplier and therefore the pricing provisions of the revised settlement as now negotiated can only be locked in until 2:00 p.m. and it doesn't mean that on another day or at a later time we would not come to other terms which are also acceptable, but we just wanted to make the record clear that the pricing commitments of this settlement could only be held through today's trading activities.

T. 8/28/97, pp. 6, 7.

Mr. DeMetro then provided further details with regard to the gas supply solicitation process that the Company engaged in and the Amendment to Settlement Agreement. That Amendment changed the \$52 million price reduction contemplated by the parties on August 14, 1997 to \$28 million. That modification had the effect of reducing the savings per mcf to the average residential customer from \$1.00 per mcf to \$0.54 per mcf. Jt. Exh. #2, p. 1. The Amendment also addressed certain concerns raised by the Commission at the August 14, 1997 hearing in regard to main replacement and services records. Mr. DeMetro testified as follows:

I would like to start by describing the process a little bit and briefly the process we used to solicit and select a supplier and also a little bit about what happened between the last hearing which I believe was on the 14th of August and yesterday.

We went through a process and -- where we solicited, we actually solicited proposals from seven suppliers. We received proposals from five of them . . . You will see we were sort of expecting and hoping for prices in the range of the first four and in fact did receive them in roughly in that range. We were hoping for something a little less than the lower one of those and then the last bid we received was the last one on that list. We were very surprised at the difference, and quite frankly, initially very delighted at the difference. We questioned that supplier, asked them to go

back and take a look, make sure that that was a good number.

T. 8/28/97 pp. 7, 8.

We got assurances a number of times from the supplier that the numbers were - - that they were very comfortable with it. In fact, we got the last assurance in writing from them and then true to the adage if it's too good to be true, it probably is, we received word over at the end of the weekend that they were withdrawing their bid and that they had found some major mistakes. . . .

We then asked them to rebid, . . . it was well above any of the others we had received. We immediately upon receiving that bid solicited the other four supplies to rebid and we received rebids from all of them and selected as the lowest bidder on the rebids the third supplier on that list. We then proceeded with that supplier to negotiate that price that they bid and as of yesterday concluded that negotiation and concluded it with a fixed basis. . . .

I'd like to address a little bit the issue around the pricing and the timing of the pricing with respect to the two o'clock deadline. The two o'clock deadline is related to the fact that NYMEX closes at 3:10. If we were going to execute this deal today, we would need - - it will take them about an hour to do it. So that's the basis of the two o'clock.

T. 8/28/97, pp. 9, 10.

The amendments, if we go I'll briefly go through the six amendments. . .The fifth amendment is a clarification to make it clear that when we are bidding to ten miles of main replacement, it is ten incremental miles, incremental of whatever is reimbursed by federal, state or local governments. And finally, the sixth amendment is a result of the hearing - - first hearing we had on this settlement where we committed to use our best efforts to complete as much of the service records as we can possible do within a three-year time period.

T. 8/28/97, pp. 12, 13

At the conclusion of Mr. DeMetro's direct testimony, the Commission began extensive questioning of him and the other witnesses at the hearing which included Mr. Timothy Lyons for the Company and Mr. Oliver for the Division. Mr. Oliver concluded his testimony with the following remarks:

Your alternative, your worst alternative over the next three years under this plan will be a reliable rate, not something that is jumping all over the place. . . .[T]he longer we wait to implement and we are already pushing windows as you see today, the gas cost as you move closer and closer to the winter, the strip prices tend to move up. [But] we are still and the Division still believes that these numbers as they sit today are a good deal. And the combination of those factors, not wanting to wait longer, the stability that's obtained, the protections for ratepayers against upward surges in costs that we've not been able to avoid in past years are all reasons that we think this proposal needs to be given consideration today.

T. 8/28/97, pp. 94, 95.

Based upon the presentation at the hearing, the Commission made the decision to discuss the matter at the bench and announce its decision. After discussion the amended Settlement Agreement was approved. T. 8/28/97, p. 99.; Jt. Exh. #2.

OCTOBER 16, 1997 HEARING

After the amended Settlement Agreement was approved on 8/28/97 and before the Company issued billings based upon the new lower gas costs, the Company advised the Commission that it had "discovered an error in the calculation of gas cost which underlies the price stabilization agreement." T. 10/16/97, p. 6. The error occurred in the Company's conversion from MMBtu's to Mcf's. Specifically, it divided by the MMBtu rate rather than multiplying. T. 10/16/97, p. 6. In conjunction with that discovery the parties to the Settlement Agreement reviewed the impact of that error and negotiated a Second Amendment to the Settlement Agreement. Jt. Exh. #3. Those provisions were then incorporated into a revised Settlement Agreement that was executed by the parties. Jt. Exh. #4.

The error resulted in an understatement of gas costs by approximately \$12 million. Because of the magnitude of the error, the parties found it necessary to rework various components of the Settlement Agreement. Thus, three major changes were made to the price stabilization plan. The most notable being a change of the net revenue decrease from the \$28 million contemplated in late August to approximately \$21 million. Jt. Exh. #4, p. 4. Mr. Lyon's described the other two changes:

The second change is . . . in the treatment of the environmental expenses. There were two categories of environmental expenses. The first was to be amortized over a three year period. The amendment transfers that to a ten year period and the ongoing environmental expenses were to be amortized over a five year period and this extends that up to ten years. And the impact of that is about \$2 million.

The third item that we changed . . . has to do with the cast iron main replacement, and that essentially reduces the minimum commitment, . . . - - for [sic] a ten mile commitment down to a seven mile commitment over the - - which over the course of the three years translates to a 21 mile commitment. And the impact of that is about a million-and-a-half dollars over the course of the plan.

T. 10/16/97, pp. 9, 10.

Mr. Lyons then summarized the impact of these changes and urged the Commission to approve the amended price stabilization plan:

So if you were to add up the six-and-a-half million by way of the factor change, the two million on the environmental and the million-and-a-half on the cast iron main, that cumulatively is \$10 million. Now, the total impact of the error was 12 million, so that's a \$2 million differential which basically translates to increased risks, the company's increased risks associated with the plan.

I think it's - - at this time it's kind of easy to look at some of these changes and just sort of focus on those, but I think stepping back and looking at the overall pan, it's still a very good plan and we still are offering customers an attractive decrease even at the four percent level. In fact, if you were to look at the NYMEX strip today, it's 13 cents higher than the 2.28 that was locked in at; it's 2.41. Interestingly enough, that 13 cents translates to about six-and-a-half million dollars. (emphasis added).

T. 10/16/97, pp. 10, 11.

Steven Scialabba, Chief Accountant for the Division Of Public Utilities was asked to comment on the calculation error and the resulting amendments to the Settlement Agreement. He indicated that he reviewed the Company's work papers and verified the error, and then forwarded them to Mr. LeLash and Mr. Oliver for their review. They too verified the error. T. 10/16/97, p. 30. Mr. Scialabba testified as follows in regard to the need for the amendments to the Settlement Agreement:

In coming to grips with the calculation error, basically I had to rethink the validity of the settlement in light of any required modifications to the price stabilization plan. Suffice it to say it was a shock and not a happy one, but we were guided from the beginning by certain overall goals and principles when we first started these discussions with the company back several months ago . . . to secure price reductions . . . to get price stability for customers . . . funding of

infrastructure improvements and system expansion . . . as well as securing low income funding for a number of years.

So in trying to fashion a solution to the problem which was presented about a week to a week-and-a-half ago I was guided by these principles to see if a solution could be fashioned which maintained these principles and these goals. And the result of that is this amended settlement. I believe everything remains in place in terms of those principles and those goals. . . .

. . . I don't pretend to know what the price is going to be in a year from now, but I think based upon what we know it's still is a good settlement even with this correction.

T. 10/16/97, pp. 28-30.

Mr. Ricci, counsel for The George Wiley Center indicated his clients satisfaction with the amended Settlement Agreement. T. 10/16/97, pp. 35, 36.

At the conclusion of the hearing, the Commission proceeded to render a bench decision. Chairman Malachowski noted that the reduced savings were "disappointing, but not terminal." T. 10/16/97, p. 34. He indicated that in his opinion it was "still a good deal" and that he was "ready to approve it." Id. Commissioner Racine, stating that she was "most satisfied with the integrity of the company. . . those that had. . . responsibility for the error. . . and (the manner in which) they. . . addressed it," moved to approve the second amendment to the Settlement Agreement. Whereupon it and the resulting revised Settlement Agreement was approved by vote of the Commission. Id at 35.;

Jt. Exh. #4.

AUTHORITY OF COMMISSION TO APPROVE PRICE STABILIZATION PLAN

Although the Settlement Agreement approved by the Commission in this docket was assented to by all of the parties, the Commission deemed it appropriate to review its authority to approve such a price stabilization plan prior to acting upon it. To that end, the Commission requested at the August 14, 1997 hearing that counsel for the Company provide the Commission with a memorandum of law outlining the basis for the requested Commission action. T. 8/14/97 pp. 84, 85. The memorandum was filed with the Commission on August 21, 1997. Providence Gas Company's Memorandum of Jurisdictional Authority, dated August 18, 1997. It provided an excellent, comprehensive review of the issue.

In the past, the Commission has relied upon the cost of service method in determining just and reasonable rates for the Company. Re: Providence Gas Company, Docket 2082 (1993), p. 63; Re: Providence Gas Company, Docket 2286 (1995), p. 64. The cost of service standard has received widespread support and has historically been the most popular method for determining reasonable rates. James C. Bonbright, et al Principles of Public Utility Rates, 109 (2nd ed. 1988). While that approach to rate regulation has been the tradition in this jurisdiction, there is nothing in the applicable Rhode Island statutes that require dogged adherence to the cost of service methodology. In fact, as the Company has pointed out, those statutes are silent as to the specific method to be employed by the Commission in regulating rates. A review of the pertinent statutes bears this out. R.I.G.L. §39-1-1, subsections (b) and (c) lie at the heart of this analysis:

(b) It is hereby declared to be the policy of the state to provide fair regulation of public utilities and carriers in the interest of the public, to promote availability of adequate, efficient and economical energy, communication, and transportation services and water supplies to the inhabitants of the state, to provide just and reasonable rates and charges for such services and supplies, without unjust discrimination, undue preferences or advantages, or unfair or destructive competitive practices, and to co-operate with other states and agencies of the federal government in

promoting and coordinating efforts to achieve realization of this policy.

(c) To this end, there is hereby vested in the public utilities commission and the division of public utilities and carriers the exclusive power and authority to supervise, regulate, and make orders governing the conduct of companies offering to the public in intrastate commerce energy, communication, and transportation services and water supplies for the purpose of increasing and maintaining the efficiency of the companies, according desirable safeguards and convenience to their employees and to the public, and protecting them and the public against improper and unreasonable rates, tolls and charges by providing full, fair, and adequate administrative procedures and remedies, and by securing a judicial review to any party aggrieved by such an administrative proceeding or ruling. (emphasis added).

This view is supported by decisions of the Rhode Island Supreme Court. Essentially, it has said that the Commission is free to use whatever method it finds appropriate so long as the resulting rates are "just and reasonable":

There is no statute in this state and no decision of this court which requires the public utility administrator to use any particular method in determining the fair value of the property of a public utility for rate-making purposes. . . . In [Federal Power Comm. v. Hope Natural Gas Co., 320 U.S. 591, 627, 64 S. Ct. 281, 88 L.Ed. 333] the court decided that whether a rate order is lawful is to be judicially determined not necessarily by the particular method used in computing the rate base but whether the total impact of the order is just and reasonable. The court said in 320 U.S. at page 602, 64 S.Ct. at page 288: "It is not theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry under the Act is at an end. The fact that the method employed to reach that result may contain infirmities is not then important." (emphasis added).

Narragansett Electric Co. v. Kennelly, 143 A.2d 709 (R.I. 1958).

Again, we emphasize that it is entirely within the province and expertise of the commission to determine the nature and type of factual information that must be supplied in the first instance by a utility, unless shown to be impossible or unduly burdensome in order to obtain approval of a tariff increase request. See American Can Co. v. Davis, 28 Or. App. 207, 559 P.2d 898 (1977) (determination of nature and type of facts likely to assist regulatory agency in discharging its duties is for public utility commissioner to make, and commissioner may order such studies as he deems relevant although he is not required to have any particular study or investigation made); see also, Trustees of Clark University v. Department of Public Utilities, 372 Mass. 331, 361 N.E. 2d 1285 (1977) (utility's rates need not be structured on a cost-related basis unless, after fair warning, the Department of Public Utilities requires that approach.)

New England Tel. & Tel. Co. v. Public Utilities Commission, 446 A.2d 1376, 1385 (R.I. 1982).

Other jurisdictions have upheld state commission decisions approving price control plans under statutory schemes similar to that of Rhode Island. For example, the New York Supreme Court, Appellate Division, 3rd Judicial Department, recently affirmed the authority of the New York Public Service Commission to approve a price regulation plan for Nynex without a suspension of rates, a general rate proceeding and traditional cost data.

In exercising its statutory responsibilities to ensure just and reasonable rates, the PSC has broad authority with respect to the factors to be considered and formula or formulae to be used, subject only to the limitations that there must be a rational basis and reasonable support in the record for the judgment exercised. Given the safeguards outlined in the Plan with respect to the "No Suspension" Rule, we cannot conclude that it is irrational. Rather, we find that it represents a permissible implementation of the PSC's broad discretion in selecting the means for achieving "just and reasonable" rates in economically sound and efficient services. (citation omitted).

MCI Telecommunications v. Public Service, 659 N.Y.S. 2d. 563, 571 (A.D. 3 Dept. 1997)

Furthermore, other state commissions have recognized their inherent authority to approval alternative methods of rate regulation. The Massachusetts Department of Public Utilities in a recent decision approved a price regulation plan for Nynex that had no earnings cap. In approving that plan, the Massachusetts Department of Public Utilities noted:

As we have elsewhere stated, "[i]ncentative regulation recognizes the legitimacy of profit as an important motivator for utilities, and the utility that knows it will be rewarded for efficiency and penalized for inefficient operations will take a more aggressive approach to control costs." D.P.U. 94-158, at 55. Nothing in our statute precludes harnessing incentive to improve service and profitability. The statutes are flexible enough to allow for utilities to earn increased profits within the context of a regulatory scheme that will produce substantial benefits for the ratepayers, most importantly lower rates than would be the case under ROR regulation. . .

[T]he Company's current rates are reasonable, and because those rates were derived from traditional ROR standards, they are cost-based. Any future changes in those aggregate rates will be done according to the price cap mechanism, which accounts for changes in the cost of providing services. . .

Unlike ROR regulation, where a higher return will increase the Company's revenue requirement and its rates, Nynex ability to increase its profits under price cap regulation is linked to productivity increases, and will not affect the level of aggregate or individual rates. . .

This de-linking of profits and rates under price cap regulation, as distinct from traditional ROR regulation, is the principal reason that price cap regulation can and will produce in this case just and reasonable rates, even if NYNEX should earn more than it would under ROR Regulation. Therefore, we find that above-average profits derived from productivity gains will satisfy the reasonable computation requirement of the statutes. . .

Accordingly, for all of the above reasons, we find that G.L.c.159 does not bar the department from adopting a price cap plan for NYNEX that does not contain a cap on earnings or allow for sharing of earnings.

In *Petition of New England Telephone and Telegraph Company d/b/a NYNEX for an Alternative Regulatory Plan for the Company's Intrastate Telecommunications Services*, DPU 94-50 (1995). pp. 76-78.

It is important to point out that the price stabilization plan which is presented in this docket finds its foundation in the Company's last general rate case which involved a traditional cost of service analysis. *Re: Providence Gas Company*, Docket 2286 (1995). Specifically, the price stabilization plan contains an earnings cap of 10.9% which as the plan states "is consistent with the ROE allowed in Docket No. 2286." *Jt. Exh. #4*, p. 10. In fact, it is the same rate that the Commission allowed in that docket. Thus, it can be fairly said that the price stabilization plan is a product of and derives its essence from traditional rate regulation. Furthermore, the record indicates that the parties shared and reviewed much of the same information that would normally be exchanged in a general rate proceeding. Thus, while the Commission is of the opinion that it is not bound to traditional rate regulation methodologies the price regulation plan before it is not inconsistent with those traditional methodologies.

CONCLUSION

Although at first skeptical of the implications of this far reaching plan, the Commission quickly came to see that it was the product of great effort and cooperation among the Company, the Division and the intervening parties. Clearly it represents an integrated, comprehensive, future looking strategy to meet the needs of the Company, the ratepayers and the State. At the heart of this plan is the three-year gas supply contract which brings about an immediate price reduction and locks in the lower price for three years. This fixed-price approach to gas supply acquisition is not unique to the industry. Recently, there has been considerable discussion and activity by local gas distribution companys (LDC's) and state commissions in regard to the purchasing of gas supply under fixed-price contracts. Price volatility has been cited as the main reason for the movement to this approach.

In May of 1997, the Indiana Regulatory Commission issued an order authorizing the Indiana Gas Company to purchase a portion of its gas supply under fixed-price contracts. In issuing that order, the Indiana Commission made the following findings:

Witness Lindsey further stated that Indiana Gas was considering purchasing 20-50% of its baseload supply on a fixed or collared price basis, the final amount being dependent on market conditions and the nature of the bids actually received. Witness Lindsey explained that in examining the use of fixed and collared pricing, Indiana Gas concluded that had it fixed or collared prices in the spring of 1996 for 1996/1997, it could have reduced gas costs by \$7.5-\$12.5 million, depending on the volume of gas contracted for on a fixed or collared price basis and the timing of entry into such contracts.

Based on the evidence presented, the Commission finds that recent and anticipated gas market volatility may make the acquisition of a portion of an LDC's gas supply at fixed or collared prices a reasonable practice. This price diversification is one means for responding to market volatility and addressing customer interest in price stability.

Re: Indiana Gas Company, Inc., In URC 5/28/97, Case No. 37394-GC A.54, 177 PUR 4th 581, 582.

Similarly, in July of 1997 the New Jersey Board of Public Utilities approved a stipulation authorizing an LDC to "lock in" a portion of its residential gas supply portfolio. The approved stipulation read in pertinent part as follows:

1... As described herein, the Company shall be permitted to hedge, or lock-in, the price of a portion of its residential gas portfolio commencing with the 1997-1998 LGAC period which is projected to begin on November, 1, 1997. The Company will set the LGAC charge to its residential gas customers based, in part, on the cost of the gas supplies which are acquired for these customers at the locked-in price. . . .

2. . . . The Company will acquire up to 50% of the residential customers' total annual gas supply, assuming normal weather either through fixed price transactions with gas suppliers or through financial instruments which are designed to hedge or lock-in the price for the Gulf Coast cost of gas component within the LGAC price for the residential customers. . . .

3. ..The goals of the Company's proposal are to provide its residential customers with a fixed gas price component for the LGAC period and to minimize any over/underrecovery related to the purchased gas commodity cost in the ensuing LGAC period. Therefore, the parties recognize that the prices for gas set pursuant to the Company's lock-in proposal may be greater than or less than the actual market price for gas during the LGAC period.

Re: Public Service Electric and Gas Company, N.J. BPU, 7/30/97, Docket No. GR 96070554, 179 PUR 4th 330, 331.

And in October of 1997 in a generic docket which addressed the issue of gas cost volatility, the New York Public Service Commission issued an order requiring LDC's to file plans for providing gas at a fixed price during the 1997-1998 heating season. While the New York Commission required that the fixed-price tariff be offered to only ten percent (10%) of customers, its action is a clear recognition that such an approach may be appropriate in light of the recent volatility of gas prices. In issuing that order the New York Commission noted the comments of the Public Utility Law Project of New York, Inc. (PULP):

PULP explains that during last winter unexpected gas price increases led to major bill increases for residential customers, causing hardship and spontaneous customer outrage. It says that the risks of substantial price fluctuation and dramatic price increases were left with the consumers, who are singularly unable to predict, control or hedge against

those risks.

Re: Gas Volatility, N.Y. PSC, 10/7/97, Case No. 97-G-0600, 180 PUR 4th 553, 561.

While the Commission is disappointed that the level of price decrease originally contemplated (\$52 million) did not materialize, it is of opinion that the final amount obtained (\$21 million) is as Division Chief Accountant Scialabba testified "still a good settlement", and when combined with the other elements of the plan confers substantial benefits to ratepayers. T. 10/16/97, p. 30. In particular, the Commission notes that this plan will promote economic development, improve system integrity and safety, and allow the Company to expand its operations and services. The parties have brought an excellent product to the table, a product which is the result of hard work, cooperation, and mutual trust. Of particular significance to the Commission was the testimony of Division consultants, Richard LeLash and Bruce Oliver. The Commission acknowledges their considerable expertise and experience in regard to the gas industry. Their opinions on the key issues in this matter are given great deference by the Commission. Their hands on involvement with and overwhelming support of the price stabilization plan was critical to the Commission's approval.

Of particular importance to the Commission are the reporting requirements of the plan. The Commission will expect and demand timely and complete reporting in the format set forth in Exhibit -3 to the Settlement Agreement.

ORDER

Accordingly, it is

(15446) ORDERED:

1. That the Settlement Agreement attached hereto as Exhibit "A" is hereby approved subject to the conditions, instructions and findings contained in this Report and Order.

DATED AND EFFECTIVE AT PROVIDENCE, RHODE ISLAND ON MARCH 6, 1998 PURSUANT TO A BENCH DECISION OF OCTOBER 16, 1997.

PUBLIC UTILITIES COMMISSION

James J. Malachowski, Chairman

Kate F. Racine, Commissioner

pard

1. This figure was increased as a result of a remand in Providence Gas Co. v. Malachowski, 600 A.2d 711 (1991).
2. These dockets, in general, expanded the availability of firm transportation services and enhanced the terms and conditions for transportation service.

STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS PUBLIC UTILITIES COMMISSION

Providence Gas Company - Docket No.

2581

SETTLEMENT AGREEMENT WITH AMENDMENTS

The Providence Gas Company ("ProvGas" or the "Company"), the Division of Public Utilities and Carriers (the "Division"), The Energy Council of Rhode Island ("TEC-RI") and The George Wiley Center (together, the "Settling Parties") have reached agreement on a price stabilization plan, and hereby jointly request the Rhode Island Public Utilities Commission's (the "Commission") approval of this Settlement Agreement. The Agreement provides for implementation of a price stabilization plan that includes: (1) an immediate decrease in the Gas Charge to residential, commercial and industrial sales service customers; (2) a three-year freeze in the Gas Charge and base rates at those reduced levels; and (3) the Company's commitment to substantial incremental capital investments and further unbundling of services.

I. PREAMBLE.....

A. Introduction

This Price Stabilization Agreement is the result of the Settling Parties' efforts to address a number of key issues facing the Company and natural gas consumers, as well as all Rhode Islanders. This Agreement offers customers assurances of both price stability and service reliability during a period of regulatory transition and adjustment to new market structures. The Agreement achieves these objectives while committing the Company to expand the capacity and to extend the reach of its natural gas distribution system in order to help promote the state's economic development initiatives which will benefit all Rhode Islanders.

The natural gas industry in Rhode Island is in the process of transitioning to a more competitive industry, offering customers more choices to meet their energy needs. At the same time, natural gas prices continue to be the most volatile prices in the commodity markets. While this transition is occurring, Rhode Island is also experiencing changes and is taking a number of economic development initiatives for which natural gas will play a major role in their success. With all this change comes the potential for more volatility and uncertainty.

In response, the Settling Parties now jointly sponsor the Price Stabilization Agreement, which calls for an initial price reduction from current levels, coupled with a three-year price freeze on the total price for firm sales service customers. In addition, the Settling Parties agree that the Company will commit to significant incremental capital investments that will: (1) expand the capacity and extend the reach of the distribution system; and (2) improve the safety and reliability of the existing distribution system. Further, the Settling Parties agree to proceeding with increased unbundling and eligibility. The Settling Parties also recognize and have addressed in this Agreement the hardship of the Company's low-income customers resulting from reductions in federal funding for heating assistance. Finally, the Settling Parties believe that this Agreement is in the interest of customers and represents a reasonable means of addressing key customer issues over the next three years.

B. Procedural History

On June 9, 1997, the Company petitioned the Commission requesting the opening of a docket for the development and investigation of a price stabilization plan. The Company was seeking to establish a forum which would provide interested parties the opportunity to participate in discussions with the Company towards a Settlement Agreement,

which would then be filed with the Commission for review and approval. At an open meeting on June 10, 1997, the Commission opened Docket No. 2581, and subsequently, petitions for intervention were filed and deemed granted pursuant to Rule 1.13(e) of the Commission's Rules of Practice and Procedure on behalf of the following entities: (1) The Energy Council of Rhode Island; and (2) The George Wiley Center. The Company published notice of the filing on June 17, 1997. The Commission published notice of the public hearing on June 27, 1997.

C. Parties' Statement

This Settlement Agreement is based on extensive discovery and negotiations among the Settling Parties concerning all aspects of the Company's Filing. The Settling Parties do not necessarily agree on every item of the Settlement; however, the Settling Parties agree that the outcome of this Settlement Agreement, as a whole, is just and reasonable and provides direct benefits to customers and jointly move for its approval by the Commission.

II. TERMS OF SETTLEMENT.....

A. Scope:

The Settlement Agreement covers the provisions of a price stabilization plan, as described below.

B. Term:

The Term of the Agreement is three (3) years, commencing on October 1, 1997 and continuing through September 30, 2000. Each year thereof commencing on October 1 shall be a "Term Year".

C. Rate Reduction:

This Agreement calls for modifications to the otherwise applicable Gas Charge Clause (GCC), which result in a projected net revenue decrease from current GCC prices of approximately \$21 million, or a uniform \$0.401 per Mcf decrease in the Gas Charge. The components of the net decrease include a reduction in the Gas Charge components, which is partially offset by an adjustment to the Throughput cost components related to substantial capital investments to support key economic development projects and maintain distribution system safety, reliability and integrity, as identified below. The projected net decrease of approximately \$21 million is based on: (1) the simple average of the closing prices of the NYMEX futures contracts strip from October 1997 through September 2000 of \$2.28 per MMBtu; and (2) the projected year-end GCC deferred balance of \$1.5 million; and thus, is subject to changes in both such factors. The Settling Parties agree that the Company shall update the projected net decrease based on market conditions at the time of the Commission's decision and utilize such projected net decrease in a compliance filing. To the extent that such NYMEX strip, as discussed above, decreases, then such price reduction would increase at the rate of \$525,000 per \$0.01 decrease in the simple average of the NYMEX futures contract prices from October 1997 through September 2000. Conversely, to the extent that such NYMEX strip, as discussed above, increases, then such price reduction would decrease at the rate of \$262,500 per \$0.01 increase in the simple average of the NYMEX futures contract prices from October 1997 through September 2000. The compliance filing shall include a schedule of Gas Charge factors in the format shown in Exhibit 1, consistent with the terms of this Agreement, to be in effect only during the Term of this Agreement. Such compliance filing shall also include the following addition to Section 2, Schedule A of the Company's tariff, Item 12, Modifications:

Provisions in this Section are subject to modifications through September of 2000 as ordered by the Commission in approval of a Settlement Agreement on the Price Stabilization Plan ("PSP") in Docket No. 2581. Such modifications include the following: (1) The Gas Charges under Item 3 of the Gas Charge Clause shall be reduced effective October 1, 1997, and frozen at such level until September 30, 2000 as provided for in the PSP; and (2) the firm throughput cost component in Item 4.4 of the Gas Charge Clause shall be increased effective October 1, 1997 and frozen at such level until September 30, 2000.

A bill impact analysis for the average customer in each rate class is provided in Exhibit 2.

D. Rate Freeze:

The Settling Parties agree, subject to the terms of this Agreement, that the Gas Charge factors filed in compliance with a Commission order in this docket, as well as base rates for firm services, shall be frozen for the Term of the Agreement, and the otherwise effective GCC shall resume effectiveness with a deferred gas cost account (as defined in the GCC tariff) of zero (0) upon termination of the Term of this Agreement. The Settling Parties also agree, subject to the terms hereof, that the Company shall not seek a base rate or Gas Charge increase that takes effect prior to the close of the Term. The Company may, however, file for such increase prior to the close of the Term; provided that such filing, with full suspension and compliance periods, may not take effect prior to the close of the Term. The Settling Parties agree to cooperate in effecting the intended results of this Settlement Agreement, including cooperation as to any required compliance or tariff filings.

E. Investment Commitments:

The Settling Parties agree that the Company commits to specific capital investments that will promote economic development in Rhode Island and enhance the safety, reliability and integrity of the distribution system. Such investments are as follows:

1. Economic Development

...a. The Settling Parties agree that the Company shall construct a high pressure main into and within the Quonset Point - Davisville Development.

...b. The Settling Parties agree that the Company shall construct a high pressure main south of the Tennessee gate station, providing additional natural gas service to the southern part of the Providence distribution system, including: Quonset Point - Davisville Development; and other areas in Warwick, East Greenwich and North Kingstown.

2. System Integrity

...a. The Settling Parties agree that the Company shall accelerate the replacement of cast iron and bare steel mains and services. Such commitment does not include reimbursed replacements associated with local, state, or federal construction projects. Such replacement shall increase to an average of approximately 10 miles per year, consisting of: (1) Company replacement of no less than 7 miles per year and no less than 21 miles during the Term of the Agreement; and (2) Federal Aid Projects (FAP) replacement, which has averaged approximately 3 miles per year over the past four years.

...b. The Settling Parties agree that the Company shall review, update and consolidate substantial portions of its mains and services records, replacing a basically paper file system having records dating as far back as 1874. The Company shall review, update and consolidate on a best efforts basis no less than 12%, 43% and 75%, cumulatively, of its records during FY98, FY99 and FY00, respectively. The Company would commit to doing the entire project over a three year period on a best efforts basis. The Company agrees to provide the Division with a status report for this project on a semi-annual basis during the Term.

3. Economic Development and System Integrity

...a. The Settling Parties agree that the Company shall construct a gate station and associated main in the Northwest section of the service territory.

In the event that any of the foregoing commitments are canceled, the Company would propose a corresponding adjustment to the plan in consultation with the Settling Parties, and subject to approval by the Commission.

F. IRP Commitments:

This Settlement Agreement supersedes and cancels the Integrated Resource Plan (IRP) Settlement Agreement in Docket No. 2025; however, during the Term of the Settlement Agreement, the Company will continue to provide funding for the following programs approved by the Commission in Docket No. 2025:

1. The Low Income Assistance Program (LIAP) will be funded at an increased annual level of \$1.0 million.

2. The Demand Side Management (DSM) rebate program will be funded at an annual level of \$0.5 million.

3. The Low Income Weatherization Program will be funded at an annual level of \$0.2 million.

Unused funds for these programs at the end of the first and second Term Years shall be added to the funds available for the second and third Term Years, respectively. Unused funds for the DSM rebate program at the end of the third Term Year shall be added to the Deferred Revenue Account, described in Section II. J. 3 below. Unused funds for the Low Income Assistance Program and Low Income Weatherization Program at the end of the third Term Year shall be utilized to assist low income customers in a manner agreed to by the Settling Parties and subject to approval by the Commission.

G. Unbundling Commitments:

The Agreement provides for additional staffing and technology resources as necessary to implement the unbundled service offerings in connection with its filing in Docket No. 2552. The Company shall provide unbundled service offerings to up to 10% per year of firm system throughput for Medium, Large and Extra Large C&I customers in FY98, as well as residential and small C&I customers in FY99 or FY00 .

H. Accounting Treatments:

The Company shall, during the Term of this Agreement, defer without carrying costs and amortize with carrying costs environmental expenditures on a 10-year amortization schedule and Year 2000 expenditures on a 5-year amortization schedule. This Agreement complies with provisions of FAS No. 71, paragraph 5, as amended.

I. Quarterly Reports:

During the term of this Agreement, the Settling Parties agree that the Company shall provide quarterly reports to the Commission and Settling Parties. The quarterly reports shall be based on audited financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP), as adjusted to comply with the Commission's most recent rate order. The quarterly reports will include: ROE measurement; operating revenues and expenses; capitalization; and calendar degree days. An example of the quarterly report is attached as Exhibit 3.

J. Financial Performance:

The Settling Parties agree that the Company's financial performance under this Agreement based on audited financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP), as adjusted to comply with the Commission's most recent rate order, will be measured based on average return on common equity (ROE) at the end of each Term Year, which shall be filed no later than 60 days following the end of each Term Year; and shall be in accordance with the following:

1. Limitations on Common Equity

To calculate ROE at the end of each Term Year, the Company's average return on common equity shall be calculated as the average of the beginning and ending equity amount; provided that such average of common equity does not exceed \$81.0 million in FY98, \$86.2 million in FY99, or \$92.0 million in FY00.

2. Limitations on Operations and Maintenance (O&M) Expenses

To calculate annual O&M expense limitations for each Term Year, the Company shall utilize actual non-gas O&M expenses, in accordance with the FERC Form No. 2; provided that such O&M expenses do not exceed an annual threshold based on eighty-five percent (85%) of the annual Term Year increase in the simple average of Consumer Price Index (CPI) and Gross Domestic Product - Producer Index (GDP-PI) compounded from the FY96 base of \$46.5 million. The Settling Parties recognize, however, that unforeseen exogenous events which are beyond the Company's reasonable control, such as severe colder-than-normal weather, severely adverse economic conditions, changes in the tax laws or tax rates (federal, state or local), mandatory changes in generally accepted accounting principles (GAAP) or current interpretations of GAAP as applied to the Company (i.e., the continued applicability of FAS 71 to the

Company), changes in definition and/or calculation of CPI and GDP-PI, and regulatory, judicial, or legislative changes affecting the Company's costs, may cause the Company to exceed such threshold and that, under such circumstances, the Company shall calculate ROE utilizing actual non-gas O&M expenses. If a dispute arises over whether any event(s) is exogenous within the meaning of this provision, the burden of proof lies with the Company to demonstrate that the event was exogenous and had a significant impact on the Company's O&M expenses. Upon written request by the Division, the Company will provide the Division with all relevant information in its possession regarding any such change sought by the Company. Any disputes shall be resolved by the Commission.

3. Deferred Revenue Account ("DRA")

The Company will establish a Deferred Revenue Account during the Term of the Agreement. Such account shall be used in accordance with the various provisions of this Agreement and maintained on a pre-tax basis.

...a. Limitations on Return on Equity.

Under no circumstances shall the Company's ROE exceed 10.9%, as calculated hereunder, for any fiscal year during the term of this Settlement Agreement (each a "Term Year"). Such ROE limitation is consistent with the ROE allowed in Docket No. 2286, the Company's most recent rate case proceeding.

...b. DRA Allocation for First Term Year.

At the close of the first Term Year, any earnings for such year in excess of an ROE of 10.9% shall be credited on a pre-tax basis to the DRA and for any deficiency in earnings for such year below an ROE of 7.0% shall be debited against the DRA through the deferral of costs. Further, any variance in the actual GCC deferred balance on September 30, 1997 from the projected GCC deferred balance included in the compliance filing, will be credited to or debited against the Deferred Revenue Account. Any resulting positive or negative balance of the DRA shall be carried forward to the second Term Year.

...c. DRA Allocations for Second Term Year.

At the close of the second Term Year, earnings for such year will be calculated in the same manner. If earnings for such year are in excess of an ROE of 10.9%, then such revenue amount shall be credited to the DRA. If, however, earnings for such second Term Year are less than a 10.9% ROE, then DRA allocations shall be made as follows:

....(i) If and only to the extent that a positive DRA balance was carried forward from the first Term Year, the Company shall use such balance to the extent necessary to attain an ROE of 10.9% for the second Term Year; and

....(ii) If, after the application of the foregoing item (i), the earnings for such second Term Year are still less than a 7.0% ROE, then the amount of annual earnings deficiency below 7.0% shall be debited against the DRA through the deferral of costs.

Any resulting positive or negative DRA balance shall be carried forward to the third Term Year.

...d. DRA Allocations for Third Term Year.

At the close of the third Term Year, earnings for such year will be calculated in the same manner. If earnings for such year are in excess of a 10.9% ROE, then such excess revenue amount shall be applied as a credit to the DRA. If, however, earnings for such third Term Year are less than a 10.9% ROE, then DRA allocations shall be made as follows;

....(i) If and only to the extent that a positive DRA balance was carried forward from the second Term Year, the Company shall use such balance to the extent necessary to attain an ROE of 10.9% for the third Term Year; and

....(ii) If, after the application of the foregoing item (i), then earnings for such third Term Year are still less than a 7.0% ROE, then the amount of annual earnings deficiency below 7.0% shall be debited against the DRA through the deferral of costs.

Any resulting positive DRA balance at the end of the third Term Year shall then be refunded to the firm customers, and any resulting negative DRA balance at the close of the Term shall be recovered by the Company through a surcharge to customers over a reasonable period. In either case, the method of addressing any DRA balance at the conclusion of the third Term Year shall be determined by the Settling Parties and approved by the Commission.

Exhibit 3 provides an example of the ROE calculation and the quarterly earnings report which would be used to measure ROE during the Term.

K. Exogenous Changes:

Independent of other provisions included in the Agreement, the Company shall be permitted to account for in the DRA the impact of Exogenous Changes.

1. Exogenous Changes are significant increases or decreases in the Company's costs or revenues which are beyond the Company's reasonable control. Exogenous Changes include, for example, severely abnormal - weather, severe changes in economic conditions, changes in the tax laws or tax rates (federal, state or local), mandatory changes in generally accepted accounting principles (GAAP) or current interpretations of GAAP as applied to the Company (i.e., the continued applicability of FAS 71 to the Company), changes in definition and/or calculation of CPI and GDP-PI, and regulatory, judicial, or legislative changes affecting the Company's costs or revenues. If a dispute arises over whether a change is exogenous or to the quantification of such impact, the burden of proof lies with the party proposing that the change is exogenous. Upon written request by the Division, the Company will provide the Division with all relevant information in its possession regarding any change for which the Company or the Division seeks exogenous treatment.

2. The Company will notify the Settling Parties as soon as practicable in advance of such claim for recovery of any Exogenous Changes. The Company and the Division will agree within 35 days after notice (1) that the item is exogenous, and (2) any proposed quantification of the change is reasonable. Any disputes shall be resolved by the Commission.

3. The impact of any Exogenous Changes will be debited or credited to the DRA through the Term of the Settlement Agreement, and recovered at its conclusion as provided in foregoing sections.

III. EFFECT OF SETTLEMENT AGREEMENT.....

This Agreement is the result of a negotiated settlement among the Settling Parties. The discussions which have produced this Settlement have been conducted on the explicit understanding that all offers of settlement and discussions relating hereto are and shall be privileged, shall be without prejudice to the position of any party or participant presenting such offer or participating in any such discussion, and are not to be used in any manner in connection with these or other proceedings involving any one or more of the parties to this Settlement or otherwise. The Agreement by a party to the terms of this Agreement shall not be construed as an agreement as to any matter of fact or law for any other purpose. In the event that the Commission (i) rejects this Agreement, (ii) fails to accept this Agreement as filed, or (iii) accepts this Agreement subject to conditions unacceptable to any party hereto, then this Agreement shall be deemed withdrawn and shall be null and void in all respects. In the event that changes in market conditions prior to the Commission decision result in unacceptable changes to the economic benefits of this Settlement Agreement to any party hereto, then this Agreement shall be deemed withdrawn and shall be null and void in all respects.

IN WITNESS WHEREOF, the parties agree that this Agreement is reasonable and have caused this document to be executed by their respective representatives, each being fully authorized to do so. Dated at Providence this 14th day of October, 1997.

Respectfully submitted,

DIVISION OF PUBLIC UTILITIES AND CARRIERS

By its Attorneys,

Paul Roberti, Special Assistant Attorney

Dept. of Attorney General

150 South Main St.

Providence, RI 02903

PROVIDENCE GAS COMPANY

By its Attorneys,

Alycia L. Goody, Esq.

General Counsel

Providence Gas Company

Providence, RI 02903

THE ENERGY COUNCIL OF RHODE ISLAND

By its Executive Director,

Roger Buck

P.O. Box 3235

Newport, RI 02840

THE GEORGE WILEY CENTER OF RHODE ISLAND

By its Attorney

Hugo Ricci, Jr., Esq.

578 Charles Street

Providence, RI 02903

**Calculation of GCC Adjustment
Sales Customers**

	Current GCC Rate (per Mcf)	Net Adjustment (per Mcf)	Adjusted GCC Rate (per Mcf)
Residential Non-heating	\$1.684	\$(0.401)	\$1.283
Residential Heating	\$1.684	\$(0.401)	\$1.283
LLF Small	\$1.684	\$(0.401)	\$1.283
HLF Small	\$1.684	\$(0.401)	\$1.283
LLF Medium	\$6.025	\$(0.401)	\$5.624
HLF Medium	\$6.025	\$(0.401)	\$5.624
LLF Large	\$6.025	\$(0.401)	\$5.624
HLF Large	\$6.025	\$(0.401)	\$5.624
LLF Extralarge	\$3.753	\$(0.401)	\$3.352
HLF Extralarge	\$3.753	\$(0.401)	\$3.352

Providence Gas Company, Docket No. 2581, Settlement Agreement, Exhibit 1 Page 2 of 2

**Calculation of Throughput Factor
Adjustment
Transportation Customers**

	Current Throughput Rate (per Mcf)	Net Adjustment (per Mcf)	Adjusted Throughput Rate (per Mcf)
Residential Non-heating	\$0.127	\$0.465	\$0.592
Residential Heating	\$0.127	\$0.465	\$0.592
LLF Small	\$0.127	\$0.465	\$0.592
HLF Small	\$0.127	\$0.465	\$0.592
LLF Medium	\$0.127	\$0.263	\$0.390
HLF Medium	\$0.127	\$0.263	\$0.390
LLF Large	\$0.127	\$0.263	\$0.390
HLF Large	\$0.127	\$0.263	\$0.390
LLF Extralarge	\$0.127	\$0.000	\$0.127
HLF Extralarge	\$0.127	\$0.000	\$0.127

Summary of Bill Impacts

	Annual Bill				Percent
	Annual Volumes (ccf)	Current Rates	Proposed Rates	Increase (Decrease)	
Res NH	210	\$311.84	\$300.42	(\$8.42)	-2.7%
Res Heat	1,100	\$1,103.72	1,059.61	(\$44.11)	-4.0%
SL	1,360	\$1,427.27	\$1,372.74	(\$54.54)	-3.8%
ML	10,370	\$9,384.80	\$8,603.30	(\$781.50)	-8.3%
LL	44,720	\$37,694.33	\$35,901.06	(\$1,793.27)	-4.8%
XLL	178,430	\$113,334.96	\$106,179.91	(\$7,155.04)	-6.3%
SH	1,450	\$1,436.74	\$1,378.60	(\$58.15)	-4.0%
MH	10,730	\$8,931.30	\$7,935.32	(\$995.98)	-11.2%
LH	46,900	\$34,164.24	\$32,283.55	(\$1,880.69)	-5.5%
XLH	194,230	\$111,056.09	\$103,267.47	(\$7,788.62)	-7.0%

Reduction in GCC rate to sales customers:

Total three year reduction.....(\$20,755,055)

Projection of 1998 - 2000 Firm Sales (Mcf).....\$51,758,243

Reduction per Mcf.....(\$0.401)

Reduction per Ccf.....(\$0.041)

Summary of Firm Service Rates							
Rates Effective		Cust Charge	Demand	Break	Energy/Commodity		Gas/T C
October 1, 1997					Head	Tail	Va
			per Ccf	Ccf	per Ccf	per Ccf	pe
RESIDENTIAL							
Res NonHeat	Peak	\$ 7.00	N/A	15	\$0.9376	\$0.8047	
	OffPeak	\$ 7.00	N/A	15	\$ 0.9376	\$ 0.8047	
Res Heating	Peak	\$ 8.00	N/A	125	\$ 0.7915	\$ 0.5948	
	OffPeak	\$ 8.00	N/A	30	\$ 0.7915	\$ 0.5948	
Air Conditioning	OffPeak	(see above)	(see above)	N/A	\$ 0.5021	N/A	varies

COMMERCIAL/INDUSTRIAL							
Low Load Factor							
Small	Peak	\$ 13.50	N/A	135	\$ 0.8306	\$ 0.6342	
(< 5,000/yr)	OffPeak	\$ 13.50	N/A	20	\$ 0.8306	\$ 0.6342	
Medium	Sales	\$ 28.00	\$0.8069	N/A	\$ 0.1765	N/A	
(5,001 to 35,000/yr)	Transportation	\$ 28.00	\$0.8069	N/A	\$ 0.1765	N/A	
Large	Sales	\$ 65.00	\$0.8088	N/A	\$ 0.1655	N/A	
(35,001 to 149,999/yr)	Transportation	\$ 65.00	\$0.8088	N/A	\$ 0.1655	N/A	
Extra Large	Sales	\$ 250.00	\$0.8959	N/A	\$ 0.0286	N/A	
(150,000+ per yr)	Transportation	\$ 300.00	\$0.8959	N/A	\$ 0.0286	N/A	
High Load Factor							
Small	Peak	\$ 13.50	N/A	65	\$ 0.8099	\$ 0.6465	
(< 5,000/yr)	OffPeak	\$ 13.50	N/A	30	\$ 0.8099	\$ 0.6465	
Medium	Sales	\$ 28.00	\$0.8069	N/A	\$ 0.1080	N/A	
(5,001 to 35,000/yr)	Transportation	\$ 28.00	\$0.8069	N/A	\$ 0.1080	N/A	
Large	Sales	\$ 65.00	\$0.8088	N/A	\$ 0.0726	N/A	
(35,001 to 149,999/yr)	Transportation	\$ 65.00	\$0.8088	N/A	\$ 0.0726	N/A	
Extra Large	Sales	\$ 250.00	\$0.8959	N/A	\$ 0.0286	N/A	
(150,000+ per yr)	Transportation	\$ 300.00	\$0.8959	N/A	\$ 0.0286	N/A	
Air Conditioning	OffPeak	(see above)	(see above)	N/A	\$ 0.3871	N/A	varies
TRANSPORTATION - Marketer Charges							
Pool Charge FT-1		\$150.00	Per Marketer per FT-1 Pool				
			Per Marketer				

Pool Charge FT-2		\$450.00	per FT-2 Pool				
Weighted Average System Capacity Charge		\$1.0440	Per MMBtu of capacity released to Marketers on behalf of Customers				
Storage Service (FT-2)		\$0.0563	Per Ccf of Throughput				
Pool Balancing Service		\$0.0021	Per % of balancing elected above 10% - per Ccf of Pool Throughput				
Pool Standby Service	Demand	\$1.4630	Per Ccf of MADQ of Pool				
	Storage	\$0.0530	Per Ccf of Pool Throughput				