As I mentioned earlier, the closest analogy in Maine to the present case is the *Cochrane* case, where the Commission was concerned about the threat of cross-subsidization of a service that a utility was providing in a competitive market.

Q. IN ARGUING FOR THE USE OF MARGINAL COST (ON PAGE 7), DR. SILKMAN REFERS TO TESTIMONY FILED WITH THE INTERSTATE COMMERCE COMMISSION BY DRS. BAUMOL AND WILLIG IN 1981. DO YOU AGREE WITH HIS CHARACTERIZATION OF THIS TESTIMONY?

A. No, I do not. I have not seen the original testimony, but I have reviewed the order that the Interstate Commerce Commission (ICC) issued in that proceeding, which discusses the testimony. *Coal Rate Guidelines, Nationwide, Ex Parte No. 347 (Sub-no. 1)*, 1 ICC 2d 520 (1985). From my review of that order, it is clear that Drs. Baumol and Willig were ***not*** proposing the use of incremental cost in setting railroad rates. Rather, they were proposing the use of long-run marginal cost, which includes an allocated portion of the cost of the capital assets that are used to provide the service. In its order (footnote 43), the ICC quotes at length from the Baumol/Willig testimony, as follows:

> The marginal cost of a service is the additional cost that would be incurred in supplying an additional unit, or the saving in total cost that would be made possible by supplying one less unit. As such, the marginal cost of a rail service is the per-unit opportunity cost to the rail carrier of the service. Here the term "opportunity cost" refers to the value a resource can contribute if it is used on some alternative occupation instead of the one to which it is currently assigned by the railroad. Thus, marginal cost is similar in meaning to unit incremental cost and to the true economic variable cost. ***However, the definition of marginal cost makes it clear that it should include the costs of capital facilities that are fungible and economically attributable to the service, as well as the more obvious cost components such as fuel, labor, and traffic sensitive maintenance costs.***
>
> For example, locomotives and other rolling stock employed for some period of time to provide a given rail service have a significant opportunity cost for a rail carrier. If

> not utilized to supply the service in question, they could instead be gainfully utilized elsewhere in the rail network, by the rail carrier at issue, or by some other carrier. Assuming that at least some carriers do not have excess supplies of the equipment in question, or of their functional equivalents, a decrease in the quantity supplied of the service would release equipment that could decrease or delay the need of some carrier to purchase new stock for replacement or expansion. ***Consequently, it follows that the opportunity cost of the rolling stock is its replacement cost, at the current cost of capital. Thus the marginal cost of a given service includes the costs of fungible capital goods that are utilized, such as locomotives and other rolling stock, at the current cost of capital for the period of time during which they were so employed.***
>
> ***Of course, the marginal cost of a service also includes the wear and tear on capital assets and the required maintenance expenses that the supply of the service causes.*** (emphasis added)

In other words, what Baumol and Willig proposed in that case was the use of long-run marginal cost, which includes an allocated portion of the cost of replacing facilities that are used in providing the service. In the context of the present case, long-run marginal cost would be equivalent to fully allocated cost – it would include an allocated portion of the cost of the District's vessels, terminal facilities, and other fixed assets that are used to provide the service.

Moreover, on pages 19 and 20 of Dr. Silkman's testimony, the footnote implies that Alfred Kahn approves of the concept of a utility pricing services at incremental cost. I do not believe that this is accurate either. In the same ICC order (footnote 46), the ICC states as follows: "As Alfred Kahn explains in his thesis on the economics of regulation, competitive traffic ideally should cover at least its LRMC [long-run marginal cost], so as to avoid cross-subsidization. A. E. Kahn. The Economics of Regulation: Principles and Institutions. Vol. I. at 141-43 (1970)."

Again, I would emphasize that in the context of this case, there is very little if any difference between the District's long-run marginal cost and fully allocated cost.

Q. DR. SILKMAN ALSO INDICATES THAT WE SHOULD NOT BE CONCERNED WITH THE DISTRICT'S UNREGULATED ACTIVITIES BECAUSE IT IS A PUBLIC COMPANY WHOSE DIRECTORS ARE ELECTED BY CONSUMERS. DO YOU AGREE WITH DR. SILKMAN?

A. No, I do not. Obviously, I agree with his characterization of the ownership structure of the District. I was well aware of that when I prepared by direct testimony, but I found that it was unimportant in the context of this case. Just because the District is publicly owned does not mean that its unregulated activities should not be subject to the same requirements as an investor-owned utility. In fact, because the District does not have stockholders, any losses incurred by the District, and the effects of any imprudent or unreasonable decisions, would be borne by its customers. Further, ordinarily stockholders serve as a check on the business discretion of management. Where there are no stockholders, it is even more important to use fully allocated cost so that customers can see the full effect of management's decisions on both the regulated and unregulated operations. In other words, the absence of stockholder oversight makes it even more important for the Commission to ensure that the District is making sound financial and operating decisions. The best way to do that is through the use of full cost allocations so that each component of the District's business will be required to stand on its own.

Q. HOW DO YOU ADDRESS DR. SILKMAN'S ARGUMENT THAT PUBLICLY OWNED UTILITIES ARE EXEMPT FROM THE COMMISSION'S CHAPTER 820 REQUIREMENTS?

A. I assisted the Public Advocate in preparing comments on the Commission's proposed regulations that are now in Chapter 820. We looked at the issue of publicly owned water and electric utilities very closely. We examined the charters, legislative provisions, and case law governing publicly owned water and electric utilities in Maine and we concluded that these utilities were prohibited by law from engaging in unregulated business activities. The Public Advocate documented the legal restrictions on publicly owned water and electric utilities in its comments on those proposed regulations. I believe that these legal restrictions on water districts and municipal electric utilities formed the basis for the Commission exempting those utilities from Chapter 820. It has nothing to do with the fact that they are publicly owned; it has to do with the prohibitions on their engaging in activities other than the production and distribution of water or electricity for their customers.

Q. IS THE DISTRICT UNDER THE SAME TYPES OF LEGAL RESTRICTIONS?

A. No, it is not. In fact, the legislation and charter that establish the District expressly recognize that the District is permitted to engage in unregulated activities, so long as those activities are incidental to its provision of regulated service. Thus, unlike all other publicly owned utilities in Maine, the District is given the explicit authorization to engage in unregulated activities.

Q. PLEASE EXPLAIN WHY PUBLIC OWNERSHIP SHOULD NOT ALLOW THE DISTRICT TO ESCAPE RESTRICTIONS ON ITS USE OF REGULATED ASSETS TO PROVIDE UNREGULATED SERVICES.

A. Regardless of its ownership structure, precisely the same concerns are presented when a regulated monopoly seeks to use its regulated assets to provide unregulated services. Restrictions on such activities are necessary in order to protect consumers of the regulated service as well as competitors. I addressed these issues in my direct testimony and I do not believe it is necessary to repeat all of those reasons here. Suffice it to say that the ownership of a utility does not change the ways in which a utility could adversely affect its consumers and the marketplace through the failure to fully allocate costs between its regulated and unregulated operations.

Q. HAVE OTHER REGULATORY COMMISSIONS DEALT WITH THIS SAME ISSUE?

A. Yes, in the order issued by the Maryland PSC earlier this year, that I referred to previously, this exact same issue was raised by consumer-owned electric companies. In that case, Choptank Electric Cooperative asked to be exempt from codes of conduct and cost allocation requirements. The Maryland PSC rejected these arguments, stating:

> The Commission is not persuaded by Choptank's arguments that because it is owned by its members/customers, it should not be subject to standards of conduct governing affiliate transactions. The cost allocation principles and standards of conduct which we adopt today govern the interactions and transactions of utilities and their affiliates. As such, they are not made any less necessary by differences in the governing structure of a particular utility. Thus, the potential for abuse which these principles and standards address is present whether the utility is investor-owned or customer-owned. Accordingly, cooperatives will be subject to the cost allocation principles and standards of conduct which are adopted herein.

Re Affiliated Transactions and Affiliate Standards of Conduct of Companies Providing Gas or Electric Service, 183 PUR 4th 277 (Md. PSC 1998). *See also Municipality of Anchorage d/b/a/ Anchorage Telephone Utility*, 111 PUR 4th 524 (Alaska PUC 1989) (abstract), where a municipally owned utility was required to place its future unregulated operations in a separate subsidiary.

I am in complete agreement with the reasoning of the Maryland PSC on this point. The ownership of a utility makes no difference in the need to protect consumers and competitors from the improper allocation of costs, or other methods of cross-subsidization, when a regulated monopoly enters a competitive business.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

BEFORE THE
STATE OF MAINE
PUBLIC UTILITIES COMMISSION

OLDE PORT MARINER FLEET, INC. Complaint Regarding Casco Bay Island Transit District's Tour and Charter Service	Docket No. 98-161

Direct Testimony of
Scott J. Rubin

on Behalf of
Maine Public Advocate and
Olde Port Mariner Fleet, Inc.

July 13, 1998

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Scott J. Rubin. My business address is 3 Lost Creek Drive, Selinsgrove, PA 17870-9357.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am a independent attorney and consultant, specializing in matters affecting the public utility industry.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS CASE?

A. I have been asked by the Public Advocate and Olde Port Mariner Fleet, Inc. ("Olde Port") to evaluate the procedures that are used by Casco Bay Island Transit District ("the District") to separate its regulated and unregulated operations and to make recommendations concerning appropriate separations and cost allocation procedures.

Q. WHAT ARE YOUR QUALIFICATIONS TO PROVIDE THIS TESTIMONY IN THIS CASE?

A. I was employed by the Pennsylvania Office of Consumer Advocate ("OCA") from 1983 through January 1994 in increasingly responsible positions. Since January 1994, I have been an independent public utility consultant and attorney. I have developed substantial expertise in matters relating to the economic regulation of public utilities. I have published articles and written speeches and other presentations, on both the national and state level, relating to regulatory issues. From 1990 until I left the OCA, I was one of two senior attorneys in that Office. Among my other responsibilities in this position, I had a major role in setting the OCA's policy positions on water and electric matters. In addition, I was responsible for supervising the technical staff of that Office. I have testified as an expert witness on several occasions before this Commission, as well as in the District of Columbia and in the states of Arizona, Delaware, Kentucky, New Jersey, Ohio, Pennsylvania, and West Virginia.

Q. PLEASE SUMMARIZE YOUR RECOMMENDATIONS AND CONCLUSIONS.

A. I conclude that the District has improperly commingled its regulated (ferry) and unregulated (tour and charter) businesses. I also conclude that the District is jeopardizing both the financial well-being of its regulated operations and the economic viability of the competitive tour and charter business in Casco Bay. In order to resolve these problems, I recommend that the Commission take the following actions:

- Limit the District to "incidental" tour and charter service, which should be defined as the provision of tour and charter service on regularly scheduled ferry routes, as well as the use of one additional vessel beyond those needed for regularly scheduled ferry service.

- Order the District to adopt strict cost allocation procedures that are designed to properly assign or allocate all of its costs between its regulated and unregulated businesses. This allocation should be audited once each year by an independent auditor, who would perform and certify the audit to the Commission and make the results of the audit available to the public.

- Establish an imputation requirement that would restrict the District's ability to price tour and charter services at less than the full cost of providing those services.

- Order the District to sell the *Bay Mist* or, in the alternative, to transfer that vessel to a separate subsidiary and to prohibit the use of that vessel for the provision of regulated ferry service.

- Clarify that the purchase of any new vessel must be based on a showing that the vessel is needed to provide regulated ferry service.

- Declare void and of no effect the agreement between the District and McKinley Partners Limited Partnership that improperly ties the provision of regulated ferry services to the provision of unregulated tour and charter services.

- Order the District to negotiate a new agreement with McKinley Partners Limited Partnership that does not in any way restrict the ability of McKinley Partners Limited Partnership or any other person or business to select the tour and charter provider of its choice and that does not result in a change in the cost of regulated service depending on the choice of the provider of tour and charter services. This new agreement, and any similar agreements with other entities, should be filed with the Commission, expressly made subject to the Commission's approval, and served on all parties to this case.
- Require the District to abide by the same restrictions in providing tour and charter services that all other tour and charter operators must follow.
- Require the District to conduct all sales and promotional activities for tour and charter service through a separate sales office.
- If the District fails to comply with these actions within a reasonable period of time, the Commission should institute a proceeding to determine whether it is in the public interest to regulate the rates that the District charges for tour and charter services.

Q. WHAT IS THIS CASE ABOUT?

A. This case has two purposes which can both be achieved through the development of proper cost allocation and other business procedures. First, it is important to ensure the continued provision of economical, regulated transportation service in Casco Bay. Second, it is equally important to ensure that the District's activities in the unregulated tour and charter business do not improperly drive competitors out of business or otherwise affect the economic viability of the tour and charter business.

Q. PLEASE PROVIDE YOUR UNDERSTANDING OF THE BACKGROUND OF THIS CASE.

A. I will not try to recount the procedural history of this case, but I will give a few of the basic facts. The District provides regulated ferry service in Casco Bay. Under statute, the Commission regulates the rates that the District charges for this service and otherwise oversees the operations of the District, much as it would with any other public utility. The District also uses its regulated facilities (boats, docks, terminals, etc.) to provide unregulated tour and charter services. The District's charter and related legislation allow the District to engage in these activities, so long as they are "incidental" to the provision of its regulated service. To the best of my knowledge, the term "incidental" is not defined in the District's charter or in the statute.

This case arose primarily because of the District's purchase of a new boat, the *Bay Mist*, that is roughly six times larger than the boat that it is replacing. That purchase highlighted the District's continued expansion of its tour and charter business and, along with other facts, has caused Olde Port and other competitors in the tour and charter business to raise concerns about cross-subsidization between the District's unregulated tour and charter business and its regulated ferry service.

Q. HAS THE DISTRICT'S PROVISION OF TOUR AND CHARTER SERVICE CHANGED OVER THE PAST DECADE?

A. Yes, it has. In 1988, the District's records show a total of 13,872 cruise passengers. By 1997, the cruise ridership had increased by over 50% to 21,042. Indeed, the cruise ridership actually peaked in 1995 (when the District had two boats available for charter service) at 26,812 passengers – almost twice the level of ridership as 1988.

Q. ARE THE DISTRICT'S TOUR AND CHARTER ACTIVITIES REASONABLE AND APPROPRIATE?

A. No, they are not. The District's tour and charter activities are supposed to be "incidental" to its regulated, ferry operations. I define this incidental activity to include selling tour or charter tickets on regularly scheduled ferry service. In addition, I recognize that the District needs to have one boat that is available as a standby, in the event that another boat requires maintenance or to provide extra service during peak periods. I would consider the use of this extra, or standby, vessel for tour and charter service to be incidental to the provision of regulated ferry service. Anything beyond these services, however, I would consider to be extraneous to the provision of regulated ferry service.

Q. HAS THE DISTRICT ENGAGED IN TOUR AND CHARTER ACTIVITIES THAT GO BEYOND THESE INCIDENTAL USES?

A. Yes, it has. In 1995, the District had two boats available to provide charter service – essentially, it had two boats that it was holding for standby service. That ended in 1996, but earlier this year, the District purchased the *Bay Mist* whose primary purpose is to provide tour and charter service. Thus, the District again has two boats that are not needed to provide regular ferry service and the District intends to use both boats to provide tour and charter service.

In addition, because of improper cost allocation procedures, it appears that the District is using its regulated operations to keep its unregulated rates artificially low. This harms its regulated customers as well as competitors in the tour and charter market.

Thus, the District is providing tour and charter service that goes well beyond that which is "incidental" to the provision of regulated ferry service. Further, in providing that unregulated service, the District is charging prices that are below its cost of providing service, which has the effect of requiring consumers of its regulated service to subsidize the provision of competitive tour and charter services.

Q. HAVE YOU BEEN ABLE TO IDENTIFY A CAUSE OF THESE PROBLEMS?

A. It appears that these problems have been caused by two factors. First, while the District properly recognizes the need to fully allocate its costs between regulated and unregulated service, it has not performed those cost allocations properly. The result is that the District's tour and charter business has not been recovering all of its costs. Second, in certain key aspects of its operations, the District has failed to distinguish between its dual roles as the monopoly provider of regulated services and as one business among many in a competitive market.

Q. PLEASE DISCUSS THIS FIRST PROBLEM – THAT THE DISTRICT HAS NOT PROPERLY ALLOCATED COSTS TO ITS UNREGULATED BUSINESS.

A. Olde Port witness Peter Ashton will discuss the cost allocation issues in detail. I will provide a brief overview of the problem, to place Mr. Ashton's testimony in perspective. The District properly recognizes that it is absolutely essential for it to fully allocate (or directly assign) all costs between its regulated and unregulated operations. However, the District has made several mistakes in performing those cost allocations. I will point to two examples, but Mr. Ashton will provide a full analysis of this issue.

First, the District allocates all costs associated with its boats on the basis of the actual number of hours or miles that the boat operates. That is, the ***reasons*** for the boat's purchase are completely ignored in allocating the costs of the boat. To use a simple example, if in a particular year a boat is used for 99 hours for regulated service and is used for just 1 hour for tour and charter, then 99% of the cost of the boat would be assigned to the regulated business. If the boat was idle because it needed to be repaired or because tour and charter business did not materialize, then the costs of all of this unused capacity would be assigned to the regulated operations.

Putting it in terms of an electric utility, the District's cost allocation method would be equivalent to allocating the cost of every power plant solely on the basis of the amount of energy that the plant produced. There would be no recognition that the plant is also built to provide a certain amount of capacity and that this capacity provides a benefit to different types of customers.

For the District, this problem became glaringly apparent when it purchased the *Bay Mist*. In purchasing that boat, the District stated that the boat would be used primarily for tour and charter service and only occasionally (10-15 days per year) for regulated ferry service. The rest of the time, the boat would be available for tour and charter business. In other words, while the *Bay Mist* may perform some function for the regulated operations of the District, it is being purchased in large part to compete in the unregulated tour and charter business. But if the District is not successful in obtaining tour and charter business for this boat, then most of the costs of the boat would be assigned to the regulated ferry operation.

Q. PLEASE DISCUSS YOUR SECOND EXAMPLE.

A. My second example of the District's erroneous cost allocation is even more glaring than the first. The District does not allocate ***any*** of the cost of operating, maintaining, and depreciating its vessels and terminal to its tour and cruise business (except for the Bailey Island cruise which has vessel expense allocated to it). That is, even though the District sells tour and cruise tickets on regularly scheduled ferry service, and uses the terminal facilities to conduct its tour, cruise, and charter business, it does not allocate any of the cost of operating these boats or the terminal to its unregulated operations. The District confirms that it is not allocating any of the vessel costs to its tour and cruise business in response to OPMF Follow-up Request 9 (Exhibit ___) and that it is not allocating any of its terminal costs to any portion of its tour and charter business in response to OPMF Follow-up Request 5(c) (Exhibit ___). The result, of course, is that customers of the District's regulated ferry service pay 100% of the cost of operating and maintaining these vessels on their regular ferry routes and 100% of the cost of the terminal, even though the District uses these vessels and terminal facilities to sell unregulated tour and cruise service.

Q. HOW DOES THIS AFFECT THE DISTRICT'S REGULATED CUSTOMERS.

A. The District's cost allocation procedures assign too much of the cost, and too much of the risk, to the District's regulated operations. That is, the District attempts to recover 100% of the cost of its terminal facilities, 100% of the cost of operating its ferry service, and most of the cost of its idle capacity from its regulated customers. Even though the District uses these same facilities to provide unregulated, competitive services, the District is requiring its regulated customers to pay all of this cost. This results in a regulated cost of service that is higher than it should be which, ultimately, will result in the District's regulated rates being set higher than they should be set.

In addition, the District is undertaking risky, competitive ventures but is assigning that risk to its regulated customers. The District is engaging in competitive activities that are subject to numerous types of risk that it does not face in its regulated activities (such as, poor weather, economic downturns, litigation, and competition from other service providers). Unfortunately, the District has further increased its exposure to risk by purchasing the *Bay Mist*, as I will discuss below. The District's ability to pay for that vessel will depend on its ability to compete successfully in the unregulated tour and charter market. If it fails to compete successfully, then regulated consumers may be faced with a higher debt burden and other additional expenses associated with a vessel that is not needed to provide regulated service.

In summary, the District's failure to allocate costs in a proper manner has resulted and will continue to result in the District's regulated customers bearing higher costs and increased risk than they should bear. Proper cost allocation procedures would result in a portion of these costs and risks being allocated to the District's unregulated operations.

Q. HOW DO THESE COST ALLOCATION PROBLEMS AFFECT THE DISTRICT'S COMPETITORS?

A. Competitors are adversely affected by the District's ability to assign much of the cost of unused capacity to its regulated operations. This is a normal cost of doing business for a tour and charter operator, but the District is able to have much of this cost absorbed by its regulated operations. In addition, as Mr. Ashton explains, there are several other cost allocation issues that result in the District not recognizing the full cost of providing tour and charter service. This results in the District's prices for tour and charter service being artificially low, which jeopardizes the economic viability of the competitive market for these services. The District's failure to properly allocate costs appears to have resulted in its charging less than its cost (and less than competitors must charge) for tour and charter services.

Q. IT SOUNDS AS IF YOU ARE SAYING THAT THE DISTRICT'S CUSTOMERS AND COMPETITORS SHARE THE SAME INTEREST IN THIS CASE. IS THAT ACCURATE?

A. Yes, it is accurate. In this instance, both regulated consumers and competitors share an interest in seeing that costs are allocated properly and that the District does not subsidize its unregulated operations with funds from its regulated operations. I will go back to one of the examples that I discussed above to illustrate this point. The District is not allocating any of the cost of its terminal facilities to its unregulated business. This means that 100% of the cost is going into the regulated cost of service. This will exert upward pressure on the District's regulated rates, harming consumers. This improper cost allocation also allows the District to charge less than the true cost of service for its unregulated service. This makes it much more difficult for competitors to compete with the District for unregulated tour and charter services.

As I said, this is just one example. Throughout my review of the District's operations, I find a consistent pattern of improperly assigning costs and risks to regulated operations. This results in harm to consumers of regulated ferry service and in harm to competitors in the tour and charter market.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that the District should be required to amend its cost allocation procedures, as Mr. Ashton discusses in detail, to ensure that it is properly recognizing the cost of each of its lines of business. In addition, I recommend that the District retain an independent auditor to review and certify to the Commission that the allocation has been properly performed. This audit should be filed with the Commission and made available to the public. It appears that the auditor also will need to instruct the District's personnel on proper cost allocation procedures.

Q. WHAT DO YOU RECOMMEND TO ADDRESS THE PROBLEMS IDENTIFIED BY MR. ASHTON CONCERNING THE DISTRICT'S FAILURE TO PRICE ITS COMPETITIVE SERVICES TO RECOVER THE FULL COST OF PROVIDING THOSE SERVICES?

A. I recommend that the Commission adopt an imputation requirement, similar to the imputation requirement that governs the provision of competitive telecommunications services by the Bell Operating Companies under the Federal Telecommunications Act. An imputation requirement establishes a price floor for the provision of competitive services, based on the full cost of providing that service. A utility is permitted to charge more than the imputed cost, depending on market conditions, but it cannot charge less than the price floor. This protects consumers of regulated services from having to subsidize a utility's competitive activities, and it also protects competitors from predatory pricing.

Q. ONE OF THE PROBLEMS YOU HIGHLIGHTED INVOLVES THE DISTRICT NOW HAVING TWO VESSELS THAT CAN BE USED TO PROVIDE TOUR AND CHARTER SERVICE. PLEASE EXPLAIN YOUR CONCERN ABOUT THIS SITUATION.

A. As I stated earlier, I have no problem with the District maintaining one boat to be used as a standby vessel -- a boat that can be placed in service on short notice if a regular boat requires maintenance or if customer demand for regulated ferry service peaks for a short period of time. Before the acquisition of the *Bay Mist* earlier this year, the District already had this standby vessel. According to the District's response to OPMF Follow-up Request 18 (Exhibit ___), the *Island Romance* performed this standby function. I also have no concerns about this standby vessel being used for unregulated tour and charter service when it is not needed to provide ferry service. I consider that to be a cost-effective use of such standby capacity and consistent with the "incidental" restriction on the District's provision of tour and charter service.

However, with the District's purchase of the *Bay Mist* earlier this year, the District now has two standby boats and the District intends to use them both to provide tour and charter service. I do not consider this to be proper or consistent with the "incidental" restriction on the provision of tour and charter service by the District. Essentially, the District has purchased a second boat so that it can enhance its presence in the tour and charter market.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that the District should be required to sell the *Bay Mist* because it is not needed in order to provide regulated ferry service. If the Commission rejects this recommendation, then I recommend that the District should be required to transfer the *Bay Mist* to an unregulated subsidiary, that the District should be prohibited from using the *Bay Mist* to provide regulated ferry service, and that no costs associated with the *Bay Mist* should be charged to regulated consumers.

I also recommend that the Commission make it clear that, in the future, it will approve financing requests for the purchase of a vessel only when the District can clearly demonstrate that the vessel is needed to provide regulated ferry service.

Q. YOU MENTIONED EARLIER THAT THE DISTRICT HAS FAILED TO RECOGNIZE ITS DUAL ROLE AS A PROVIDER OF BOTH A MONOPOLY SERVICE AND A PARTICIPANT IN A COMPETITIVE MARKET. PLEASE EXPLAIN THIS IN MORE DETAIL.

A. I will highlight two concerns in this area. First, earlier this year, the District entered into a revised agreement with McKinley Partners Limited Partnership ("McKinley" or "MPLP"). A copy of the agreement is being filed along with this testimony as Exhibit ___. The agreement concerns the provision of ferry service to a development on Great Diamond Island, called Diamond Cove, that is being developed by McKinley. The basic purpose of the agreement is for the District to provide a scheduled, additional stop on Great Diamond Island in order to serve Diamond Cove residents. The District agreed to provide a "basic" level of service at no additional cost to McKinley. In addition, the District agreed to negotiate on a year-by-year basis the provision of "supplemental" service to Diamond Cove. McKinley is required to reimburse the District for the difference between the cost of the supplemental services and the revenues that the District receives from people and businesses utilizing that service, according to a set formula.

In addition, however, the agreement contains section 6 entitled "MPLP commitment to use of the Transit District services in order to reduce operating losses." This section of the agreement requires McKinley to use the charter services of the District "to the full extent that it is able to do so." ***Section 6a***. McKinley also agreed to "encourage all travelers to Diamond Cove and all commercial establishments transporting passengers, freight or vehicle to Diamond Cove, to utilize the services of the Transit District to Diamond Cove to the maximum extent reasonably possible." ***Section 6b***. Further, McKinley is provided with a direct monetary benefit for using, and encouraging others to use, the District's charter services. According to Exhibit B of the agreement, McKinley is credited with 65% of the net revenue that is generated by all Transit District charters to Diamond Cove.

In other words, this agreement ties together the provision of regulated ferry service with the provision of unregulated charter service, such that the customer (McKinley) receives a lower price for the regulated service if it uses and encourages others to use the unregulated service.

Q. WHAT ARE THE EFFECTS OF THIS KIND OF AN AGREEMENT?

A. Obviously, this type of agreement is extremely anti-competitive. The District is using its leverage as the only authorized provider of regulated service to obtain a benefit in the competitive tour and charter market. There is no way that a competitor can compete with this deal, because the District is assigning 65% of its profit on each trip to McKinley. Moreover, that profit is being calculated without any assignment of capital expenses (see Exhibit B to the agreement). To use a very simple example, let's assume that the District and competitors each charge $100 for a particular charter. The out-of-pocket costs (fuel, labor, etc.) are $50 and the allocated capital cost (depreciation, loan payments, etc.) of the boat is $30. So, the operator expects to make $20 on the trip to go toward its overhead, profit, and similar costs. Under the deal that the District has with McKinley, McKinley would pay $100 for the service, but would then have its subsidy payment reduced by $32.50 (65% of the net profit excluding capital costs, or 65% x ($100 - $50)), for a net cost of $67.50. The competitor cannot possibly meet this price, since it would involve charging below its cost of service.

The District acknowledges the economic impact of this agreement in its response to OPMF Follow-up Request 30 (Exhibit ___). There the District states that it engaged in various discussions since 1995 where it "touched on the fact that it was in the economic self-interest of MPLP to encourage use of the Transit District's services." In other words, the District made it clear to McKinley that McKinley would be better off using the District's unregulated services than it would be using competitors, because of the agreement that reduces McKinley's cost of supporting regulated ferry service if it uses the District for unregulated tour and charter services.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that the Commission take the following actions:

- Declare void and of no effect the agreement between the District and McKinley that improperly ties the provision of regulated ferry services to the provision of unregulated tour and charter services.
- Order the District to negotiate a new agreement with McKinley that does not in any way restrict the ability of McKinley or any other person or business to select the tour and charter provider of its choice and that does not result in a change in the cost of regulated service depending on the choice of the provider of tour and charter services. This new agreement should be filed with the Commission, expressly made subject to the Commission's approval, and served on all parties to this case.

Q. WHAT IS YOUR SECOND CONCERN ABOUT THE DISTRICT'S COMMINGLING OF ITS REGULATED AND UNREGULATED ACTIVITIES?

A. I am also concerned about the ease with which the District and potential customers can switch between regulated and unregulated services, including the ability to leave on a tour or charter and return on regulated ferry service. The District sells tours on regularly scheduled ferry service. It is one thing for a person who is not a resident to purchase a seat on a ferry-based "tour." It is quite another for that person to receive a different type of service than any of the District's competitors is permitted to provide. In short, I am urging the Commission to require the District and its competitors to play by the same rules when providing unregulated tour and charter services.

Specifically, the District's competitors are prohibited from dropping off passengers on an island and picking them up on a later voyage. Rather, if a competitor's passengers want to disembark on an island, the boat must wait for those passengers to return. Simply, all passengers who leave on a boat must return on the same boat.

The District, however, is permitted to sell "tour" tickets that allow passengers to disembark and return on another boat. The District acknowledges that this occurs in its response to OPMF Follow-up Request 25 (Exhibit ___). Thus, the District's provision of unregulated tour and charter services is not subject to the same restrictions as the tour and charter services provided by the District's competitors. This is not equitable and must be changed.

Q. WHAT DO YOU RECOMMEND?

A. I recommend that all tour and charter service in Casco Bay should be subject to the same terms and conditions, regardless of the provider. If the Commission deems it desirable to allow tour and charter passengers to disembark and return on a different boat, then all tour and charter providers should be able to provide this type of service. If, instead, the Commission considers it appropriate to require all tour and charter passengers to return on the same boat, then this restriction should apply to all tour and charter operators, including the District. The current system, which restricts tour and charter operations differently depending on the operator, is unfair and should not be allowed to continue.

Q. YOU HAVE RECOMMENDED A CHANGE IN COST ALLOCATION PROCEDURES, REVISIONS TO AN ANTI-COMPETITIVE AGREEMENT, AND OTHER REMEDIAL ACTIONS. IF THESE CHANGES ARE

MADE, WILL THAT SATISFY YOUR CONCERNS ABOUT THE DISTRICT'S COMMINGLING OF ITS REGULATED AND UNREGULATED OPERATIONS?

A. Making these changes would be a major step forward. They would remove much of the risk from consumers of the District's regulated services and properly assign costs to its unregulated operations. These changes also would help to ensure that the District does not improperly attempt to encourage captive customers of its regulated service to also become customers of its unregulated services. However, I am concerned about the ability of the Commission, customers, and competitors to continually monitor the District's operations. Cases like this one consume a large amount of resources both for the Commission and for businesses like Olde Port.

I also recommend, therefore, that the Commission take two additional actions. First, the Commission should require that the District's sales of tour and charter services must be conducted through a separate sales office. This will provide a visible and easily verifiable indication that the District is properly separating the costs of its regulated and unregulated businesses and that it is not attempting to tie its two operations together.

Second, the Commission should consider the possibility of regulating the rates that the District is allowed to charge for tour and charter service. This may be the best way to ensure that the District is not placing the risks and costs of its competitive business on its regulated customers. Having Commission-established rates for the District's tour and charter business would help to ensure that proper cost allocation procedures are being following.

I recognize that this final recommendation is a fairly drastic step. That is why I propose it as an issue for the Commission to examine, particularly if the District does not promptly comply with the recommendations that I am making concerning cost allocation and changes to its contract with McKinley.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

HOPE GAS, INC.
d/b/a DOMINION HOPE

CASE NO. 05-0304-G-42T

DIRECT TESTIMONY

OF

SCOTT J. RUBIN

On behalf of the
Consumer Advocate Division
Of the
Public Service Commission
Of West Virginia

Dated: September 6, 2005

Introduction

Q. Please state your name and business address.

A. My name is Scott J. Rubin. My business address is 3 Lost Creek Drive, Selinsgrove, PA.

Q. By whom are you employed and in what capacity?

A. I am an independent consultant and an attorney. My practice is limited to matters affecting the public utility industry.

Q. What is the purpose of your testimony in this case?

A. I have been asked by the Consumer Advocate Division (CAD) to review the relationships, charges, and cost allocations among Hope Gas, Inc. (Hope) and its affiliates, with a primary emphasis on Dominion Resources Services, Inc.

Q. What are your qualifications to provide this testimony in this case?

A. I have testified as an expert witness before utility commissions or courts in the District of Columbia and in the states of Arizona, Delaware, Kentucky, Illinois, Maine, New Jersey, New York, Ohio, Pennsylvania, and West Virginia. I also have served as a consultant to the Connecticut Department of Public Utility Control, private businesses, non-profit organizations, national utility trade associations, state governments, and municipally owned utilities. I also have testified as an expert witness on utility matters before committees of the U.S. Congress and the Pennsylvania House of Representatives.

Prior to establishing my own consulting and law practice, I was employed by the Pennsylvania Office of Consumer Advocate (OCA) from 1983 through January 1994 in increasingly responsible positions. From 1990 until I left the OCA, I was one of two senior attorneys in that Office. Among my other responsibilities in that position, I had a major role in setting the OCA's policy positions on water and electric matters. In addition, I was responsible for supervising the technical staff of that Office. I also testified as an expert witness for that Office on rate design and cost of service issues. During my last four years with that Office, I chaired the Water Committee of the National Association of State Utility Consumer Advocates (NASUCA).

Throughout my career, I developed substantial expertise in matters relating to the economic regulation of public utilities. I have published articles, contributed to books, written speeches, and delivered numerous presentations, on both the national and state level, relating to regulatory issues. I have attended numerous continuing education courses involving the utility industry. I also periodically participate as a faculty member in utility-related educational programs for the Institute for Public Utilities at Michigan State University, the American Water Works Association, and the Pennsylvania Bar Institute.

Q. **What is your specific expertise concerning relationships between utilities and their affiliates, and associated cost allocation and related issues?**

A. I began studying the relationships between utilities and their affiliates in numerous rate cases during the 1980s, and more formally for the Water Committee of NASUCA in the early 1990s. Since then, I have testified on several occasions concerning the appropriate relationships and costs among utilities and affiliated companies, including, for example, the following cases:

- *Re Consumers Maine Water Company Request for Approval of Contracts with Consumers Water Company and with Ohio Water Service Company*, Me. Public Utilities Commission, Docket No. 94-352 (1994), on behalf of the Maine Office of Public Advocate.

- *In the Matter of the Regulation of the Electric Fuel Component Contained within the Rate Schedules of Cincinnati Gas and Electric Co. and Related Matters*, Public Utilities Commission of Ohio, Case No. 97-103-EL-EFC (1998), on behalf of the Ohio Office of the Consumers' Counsel.
- *Olde Port Mariner Fleet, Inc. Complaint Regarding Casco Bay Island Transit District's Tour and Charter Service*, Maine Public Utilities Commission, Docket No. 98-161 (1998), on behalf of the Maine Office of Public Advocate.

In addition, I have examined these issues as a consultant in numerous rate cases involving various water and wastewater utilities that receive and/or provide services to affiliated companies.

Overview of Hope's Affiliated Transactions

Q. Please describe the relationship between Hope and its affiliates.

A. Hope is a wholly owned subsidiary of Dominion Resources, Inc. (Dominion). Dominion is a holding company that owns electric distribution systems in Virginia and North Carolina, and natural gas distribution systems in West Virginia, Ohio, and Pennsylvania. In addition, Dominion owns power plants, natural gas storage, and natural gas production facilities in several states, as well as other types of businesses. Many services are provided for the parent company, Hope, and the dozens of other subsidiaries through Dominion Resources Services, Inc. (DRS or Service Company).

In addition, Dominion's largest distribution utility, Virginia Electric Power Company (VEPCO), provides billing, call center, and collections services for Hope and the other distribution utilities. Another Dominion affiliate, Dominion Transmission, provides natural gas transmission services for Hope. Affiliates also lease office space to Hope and provide it with various other services.

Q. Does Hope provide services to any of its affiliates?

A. Yes, Hope has an agreement with Dominion Products and Services, Inc. (DPS), formerly known as CNG Products and Services (CNGPS), under which Hope provides certain billing, payment processing, and construction services. I will discuss this agreement in more detail later in my testimony. In addition, there are mutual aid agreements among the gas distribution utilities, so that personnel from one company can assist the other during emergencies or for other reasons. With the exception of DPS, however, it is not typical for Hope to provide services to any of its affiliates.

Q. Which of these affiliated relationships will be the focus of your testimony?

A. My testimony will focus on the relationships between Hope and DRS (which includes charges from VEPCO that come through DRS for customer-related services). I also will discuss the contract between Hope and DPS.

Impact of the Energy Policy Act of 2005

Q. Is there any type of federal regulation of Hope's relationships with its affiliates?

A. Yes, at least for a few more months. Dominion is a registered holding company under the Public Utility Holding Company Act of 1935 (1935 Act). As such, agreements among Dominion affiliates are subject to regulation by the Securities and Exchange Commission (S.E.C.). However, Congress recently enacted the Energy Policy Act of 2005 which includes a subtitle called the Public Utility Holding Company Act of 2005

(2005 Act).[*] The 2005 Act repeals the 1935 Act effective February 2006 and eliminates S.E.C. jurisdiction over utilities' affiliated relationships.

Q. What does this mean for Hope's relationship with its affiliates?

A. I don't know. It is not at all clear how large, interstate utility holding companies like Dominion will choose to operate. The 1935 Act required Dominion to have a service company and restricted the Service Company from recovering more than its actual costs from affiliates. The 2005 Act contains no such requirement. With the repeal of the 1935 Act, Dominion will need to decide what type of relationship it wants to have among its subsidiaries and, of course, it will need to comply with state affiliated interest provisions in those states where it provides utility service.

In addition, under the 1935 Act, the S.E.C. conducted periodic audits of the Service Company to ensure that it was billing no more than its costs and to ensure that Dominion complied with Dominion's cost allocation manual and procedures. The last such audit was completed in 2004 and examined expenses for the year 2001. Since the S.E.C. will no longer regulate utility holding companies, it will not conduct further audits of the Service Company or other Dominion affiliated activities (such as its money pool).

The 2005 Act gives the Federal Energy Regulatory Commission (FERC) the authority to review utility affiliates' books and records, but those reviews are limited to any impacts on FERC-jurisdictional rates; that is, wholesale rates.[†]

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[*] Sections 1261-1277 of the Energy Policy Act.
[†] Section 1264(a) of the 2005 Act.

Q. What will this mean for the West Virginia Public Service Commission?

A. That's another very good question that I can't fully answer today. If Dominion decides to change the way it provides services among its affiliates, or if it decides to change the cost allocation formulas, or make any other changes due to the repeal of the 1935 Act, then this Commission will need to carefully review those changes. In addition, and perhaps more importantly, the Commission will no longer be able to rely on the S.E.C. to ensure the financial integrity of Dominion or provide basic review and oversight of the affiliated relationships within the holding company. The 2005 Act specifically preserves states' authority to regulate utilities' affiliated relationships, stating: "Nothing in this subtitle shall preclude the Commission [FERC] or a State commission from exercising its jurisdiction under otherwise applicable law to determine whether a public utility company, public utility, or natural gas company may recover in rates any costs of an activity performed by an associate company, or any costs of goods or services acquired by such public utility company from an associate company."*

At this point, about the only thing I can say with certainty is that the Commission will need to be much more vigilant about its oversight and regulation of Hope's relationship with its affiliates. It certainly looks like the federal government has ceded regulation of these activities to the states.

Q. What implications does the repeal of the 1935 Act have for the current rate case?

A. That's another interesting question. While the repeal of the 1935 Act is certainly a "known" change, it will take place more than a year after the end of the test year in this case. Further, while the change in the law is known, its effects on Hope are not yet

* Section 1267(b) of the 2005 Act.

"measurable" because we do not know whether or how Dominion will choose to restructure the relationships among its subsidiaries. For purposes of reviewing Hope's relationships with its affiliates in this case, therefore, I have not considered any effects from the repeal of the 1935 Act.

I believe, though, that it is extremely important for the Commission to closely monitor and review any changes that Hope proposes in its affiliated agreements and relationships. In addition, between now and February when the repeal of the 1935 Act takes effect, the Commission may want to consider whether any changes in state statutes, or its own regulations and procedures, are required to fully protect the interests of utility customers from potential abuses by utility affiliates.

Hope's Relationship with the Service Company

Q. Let's turn to Hope's relationship with the Service Company. Is there an agreement between Hope and DRS that governs that relationship?

A. Yes, there is. The current version of the agreement is dated January 1, 2003. I have attached a copy of the agreement as Schedule SJR-1.

Q. Generally, how is the agreement structured?

A. The agreement provides that DRS may provide various types of services to Hope and that DRS will bill Hope no more than DRS's actual cost for providing the services. Hope is not required to procure any particular service from DRS. Specifically, the agreement states that Hope (called "the Company" in the agreement) "may, from time to time and at the option of the Company, agree to purchase such administrative, management and other services from DRS." Sch. SJR-1, p. 1. The agreement also states that DRS will provide services to Hope "only at the request of" Hope. Id. Further, Hope is required to affirmatively notify DRS by December 31 of each year of the services that Hope intends to receive from DRS during the following year.

Q. Is that a reasonable way to structure an arrangement between a utility and an affiliated service company?

A. Yes, on paper the structure of the agreement is fine. It looks like Hope has the option to procure a service from its affiliate, provide the service itself, buy it on the open market, or decide it does not need the service at all. The agreement looks like it would allow Hope to choose the service provider that best meets its needs and would help to ensure the reasonableness of the costs incurred by Hope. The problem comes with how the agreement actually works in practice.

Q. What do you mean?

A. Hope is not making independent decisions about whether to purchase any particular service from the Service Company. We asked Hope a series of questions to try to understand the process that it uses to exercise its rights under the DRS agreement. From the responses (CAD questions J-13, J-14, J-16, J-33, J-34, and J-35 – attached as Schedule SJR-2), it is apparent that there is no one at Hope who makes any such decision or who has the authority to tell the Service Company that Hope does not want a particular service. The decisions are made at the corporate level and, of course, at that level the interest is in standardization and in having Service Company personnel fully utilized.

Q. But in response to CAD J-13 (Sch. SJR-2, p. 1), Hope says that it makes sense to purchase services from DRS because DRS doesn't charge a profit and captures economies of scale that Hope couldn't receive on its own. Isn't this true?

A. While it is true that DRS doesn't charge a profit and that it is much larger than Hope, that's very different than saying that DRS's costs are lower than those that prevail in the open market or that Hope could obtain elsewhere. First, DRS is based in Richmond, VA, and pays salaries and benefits based on those that prevail in that market. Those could be significantly higher than what Hope would need to pay to attract similar levels of expertise in Clarksburg, WV. (For example, a salary comparison calculator at salary.com indicates that salaries in Richmond tend to be 4.6% higher than comparable salaries in Parkersburg, WV, which is the closest market to Clarksburg listed on the web site.)

More importantly, Dominion and DRS have an enormous overhead that has little to do with providing safe and reliable utility service in Hope's service area. Dominion maintains a fleet of three (and in some months four) airplanes so its executives can easily get to their far-flung corporate holdings from Richmond. (Dominion's holdings include, for example, operations in Canada, Puerto Rico, New England, several Midwestern states, Louisiana, Texas, and Oklahoma, to name just a few). DRS pays more than $8 million per year for aircraft leases, pilots, and operating and maintenance costs on its planes – and those are part of the "actual costs" that DRS charges to Hope.

Similarly, Dominion has multiple layers of management with six-figure (or higher) salaries, stock options, incentive compensation, country club memberships, European travel, and other lavish benefits. None of those are required for Hope to provide safe and reliable utility service in West Virginia, but they all constitute part of DRS's "actual cost" of providing service to Hope.

In other words, just because DRS doesn't charge a profit doesn't mean that its charges for performing certain services are lower than what Hope could obtain from other service providers. It also doesn't mean that Hope even needs to procure any particular service from DRS.

Determining the Reasonableness of Hope's Customer Records & Collections Cost

Q. That all sounds good in theory, but how can you determine if Hope is paying more or less than it could if it purchased services from someone else, or supplied them itself?

A. That's difficult to do because Hope utterly failed in its responsibility to make a well-informed decision about purchasing these services. Hope never investigated its options and never explored the market for obtaining these services elsewhere. Dominion executives simply mandated that Hope would use the Service Company (see Schedule SJR-2, page 6). There is, however, one way to get at least a strong indication of whether Hope is paying more than it should for some of these services – and that is by comparing Hope's costs to those of comparable utilities.

In particular, I will focus on costs for customer records and collections (FERC account 903). Account 903 includes all costs associated with billing, collection, service orders, customer records, call center, and related activities. Those activities must be provided by every utility and are an area where you would expect there to be some significant economies of scale, which should give Hope an advantage as part of the

Dominion group of companies. So if DRS is, in fact, able to provide reasonably priced services and capture economies of scale, I would expect that to be apparent in the customer service function.

Q. Before you discuss the results of your comparison, please explain how you selected utilities that are comparable to Hope.

A. I began by selecting investor-owned, natural gas distribution utilities in West Virginia or a neighboring state that had utility annual report data available on-line for 2004 (this excluded Maryland and Virginia). I then limited the comparison group to those utilities that had residential customers, total customers, sales revenues (excluding transportation) and sales volumes (excluding transportation), within a range of 1/2 to 2 times those of Hope. Hope has about 116,000 customers, so I'm roughly comparing Hope to gas distribution utilities with between 58,000 and 232,000 customers, in addition to the other factors. Based on these criteria, I identified eight utilities that are comparable to Hope. Unfortunately, data for one of them (National Fuel Gas Distribution Corp. in Pennsylvania) are not available because that company's annual report also included data for its much larger operations in New York state. So I am left with seven companies that are comparable in size and scope of operations to Hope.

Q. What are those companies?

A. The companies are Atmos Energy, Columbia Gas, and Union Light Heat & Power – all in Kentucky; PG Energy, PPL Gas, and TW Phillips – all in Pennsylvania; and Mountaineer Gas in West Virginia. The customers and sales figures for each of these companies, and for Hope (both 2004 actual and going level) are shown in Schedule SJR-3. They range in size from TW Phillips with about 61,000 customers and $102 million in sales revenues to Mountaineer Gas with about 203,000 customers and $266 million in sales revenues.

Q. Are any of your comparison companies also affiliates of a larger utility holding company?

A. Yes, all of these companies, except TW Phillips, are affiliates of larger utility holding companies. TW Phillips is a stand-alone natural gas distribution utility. The affiliations of the companies in my comparison group are briefly described as follows:

- Atmos Energy owns gas distribution utilities in 12 states, serving about 3.1 million customers;
- Columbia Gas is part of NiSource, a gas and electric holding company serving about 3.7 million customers (about 3.3 million gas and 0.4 million electric) in 9 states;
- Union Light Heat & Power is a subsidiary of Cinergy, which has about 1.5 million electric customers and 0.5 million gas customers in three states;
- PG Energy is part of Southern Union, which has about 1 million natural gas retail customers in 4 states;
- PPL Gas is an affiliate of an electric distribution utility in Pennsylvania, which has about 1.3 million electric customers, and about 75,000 gas customers, in Pennsylvania;
- Mountaineer Gas is an affiliate of Allegheny Energy, which in 2004 served about 1.8 million electric and gas customers in 5 states.

Q. How do these holding companies compare to Dominion?

A. They are similar but generally smaller in size and scope than Dominion. Dominion serves about 4 million customers in 5 states. This is somewhat larger than any of the holding company systems in the comparison group, but that should only work to Dominion's advantage if Hope's theory is correct.

Q. How did you compare Hope to these other companies?

A. I tabulated the amount that each company reported in account 903 (which I'll simply refer to as "customer cost") on its 2004 annual report and calculated three ratios based on that figure: (1) customer cost per customer; (2) customer cost per $1,000 in sales revenue (excluding transportation); and (3) customer cost per million cubic feet (MMCF) of sales (excluding transportation). I show the comparison on Schedule SJR-4.

Q. How do Hope's 2004 customer costs compare to these comparable gas distribution utilities?

A. Hope's per books costs, as reported in its 2004 annual report, are among the lowest in the comparison group. Its average cost of $15.82 per customer is lower than all but one of the companies; its average costs per $1,000 of revenue and per MMCF of sales are lower than all but two of the others.

Q. So doesn't that support Hope's assertion that it's cheaper for it to buy these services from Dominion than to obtain them elsewhere?

A. If Hope's revenue requirement in this case were based on its per books expenses that might be accurate. However, Hope is proposing a going-level adjustment to its customer costs of $3.17 million -- nearly tripling the cost from $1.8 million to $5.0 million. The adjustment, as I understand it, reflects the fact that some costs which Hope booked as outside services (account 923) are really customer costs that belong in account 903.

Q. What happens to your comparison when you use Hope's $5.0 million going-level claim for account 903, rather than the $1.8 million per books amount?

A. The difference is dramatic. Rather than having customer costs among the lowest of the comparable companies, Hope's customer costs are actually the highest by a wide margin. In fact, they are twice as much or more than those incurred by comparable gas distribution utilities. Hope's going-level average cost per customer is over $43 per year, compared to the average in the comparison group of less than $20 per customer per year. The next highest cost is $28 per customer – about 2/3 of the amount Hope incurs. Similarly, on a revenue basis, Hope's going-level cost of over $34 per $1,000 in revenue is more than twice as high as the average and more than 50% higher than the next highest cost ($22). The result is similar if the comparison is done based on the volume of gas sales – Hope's going-level customer cost of $372 per MMCF is more than 2.5 times the average of $143 and 1/3 higher than the next highest company ($279).

Q. How do Hope's costs compare to the only stand-alone gas distribution utility in your comparison?

A. Hope's going-level costs are between two and three times higher than those incurred by TW Phillips, the stand-alone gas company in this group. TW Phillips has costs that average $18.60 per customer, $11.16 per $1,000 in revenue, and $109.34 per MMCF. By comparison, Hope's going-level averages are $43.17 per customer, $34.63 per $1,000 in revenue, and $372.09 per MMCF. As I said, these are between two and three times higher than the average costs incurred by a comparably sized, stand-alone gas distribution utility.

Q. How do Hope's going-level costs compare to the comparably sized affiliates of large holding companies in your group?

A. Hope's costs are significantly higher, as I discussed above. Hope's costs are at least double those of the average, and at least one-third higher than the next highest comparably sized affiliate in my comparison group.

Q. Couldn't these other companies' annual reports reflect the same issue that led Hope to reclassify over $3 million from outside services to customer costs?

A. That is possible and I don't have a way to verify if any of the utilities properly recorded their costs in account 903 as opposed to account 923. To check this possibility, however, I also compared the level of costs recorded in account 923 (outside services) for each of the companies in my comparison group. This comparison is shown on Schedule SJR-5.

Q. What does your review of outside services costs for each company show?

A. Hope's going-level expenses in account 923 are substantially higher than most of the other companies' costs – in many instances more than five times higher. Hope's outside services costs, on a going-level basis (that is, after the customer costs are removed) are nearly $6 million. In comparison, five of the comparison companies have costs less than $0.7 million each. Those five companies <u>combined</u> have outside services costs of about $1.7 million – total for all five companies – that's less than one-third of Hope's costs.

The other two companies – PPL Gas and Columbia of Kentucky – have outside services costs that are closer to Hope's. PPL's are very similar on an average basis to Hope's going-level costs, while Columbia's range between 50 and 70 percent higher than Hope's on average.

Q. What do you conclude from looking at outside services costs?

A. I conclude that it is extremely unlikely that five of the utilities include any significant customer costs in outside services. It is possible that PPL Gas or Columbia does so but, of course, it is not possible to know that with any certainty. I conclude, therefore, that it is reasonable to assume that the amounts reported in account 903 for the comparison companies are likely to accurately represent the customer costs incurred by (or allocated to) the utility; it is unlikely that most of them include any customer costs in outside services (account 923). It is reasonable, therefore, to compare Hope's going-level customer costs to those reported by these other utilities in their 2004 annual reports.

Q. Why is this comparison of customer costs important?

A. The comparison is important because it shows that Hope's fundamental premise is wrong. Just because DRS provides services at "cost" and is much larger than Hope does not mean that DRS is the lowest-cost service provider. This comparison shows that quite the opposite is true. The customer costs – costs for billing, customer service, call center, and so on – for Hope are more than twice as high as they would be if Hope were an affiliate of a smaller holding company, or even a stand-alone gas distribution utility.

Q. Do you know why this is the case?

A. Yes, I have a good idea why this is the case. While I haven't done a full audit of the Service Company (that is well beyond the time and resources available in this rate case), I have reviewed at least certain categories of costs charged to Hope by DRS. I mentioned some of these earlier – executive compensation, a fleet of airplanes, and so on. I will discuss others later in my testimony. But the fact remains that the "actual costs" charged by DRS to Hope include millions of dollars that have been inappropriately allocated to utility operations.

Later, I will propose adjustments to some of these costs that are charged to Hope by DRS. But DRS also charges these same kinds of costs to VEPCO (the customer service provider for Hope), and such costs would become part of VEPCO's overhead charges that are billed to Hope.

Q. We'll get back to that shortly. Before we do, though, what do you propose that the Commission should do about customer costs in this rate case?

A. I propose that Hope should only be permitted to recover a level of customer costs (account 903) that is consistent with the level of costs incurred by the utilities in my comparison group. I calculate this amount on Schedule SJR-6. As that schedule shows, if Hope were an affiliate of any of those other holding companies, or even a stand-alone company like TW Phillips, its customer costs would be $2,074,000 instead of the $5,012,000 claimed by Hope. I propose that Hope's customer costs should be set at this level, which is $2,938,000 lower than Hope's going-level claim.

Q. How did you calculate that a reasonable level for Hope's costs would be $2,074,000?

A. I calculated the weighted average customer costs per customer, per $1,000 in sales revenues, and per MMCF of sales for the comparison companies. I calculated the average two ways: first, for all companies in the group; and second, excluding the highest and lowest companies in each category. I then took the higher of the two average costs and multiplied it by the relevant data point for Hope. Then I averaged the three estimates for Hope to arrive at a cost for Hope of $2,074,000.

Q. Can you take us through an example?

A. Yes. Let's look at the average cost per customer. The weighted average of all seven comparison companies is $18.22 per customer. If I exclude the highest and lowest cost companies (Atmos and Columbia), then the average increases to $19.97. I take the higher of these two averages – $19.97 – and multiply it by Hope's going-level number of customers (116,090) to get total customer costs of $2,319,000. I then went through the same type of calculation for average cost per sales revenues and average cost per MMCF of sales. I then averaged those three averages together to get the cost estimate of $2,074,000 for Hope.

Q. Do you really think it's reasonable to establish rates for a utility based on the costs incurred by other utilities?

A. Normally, I would not look at other utilities' costs when determining an appropriate revenue requirement for a utility. But this is not a normal case. Here we have a utility that has entered into a contract that gives it the right – I would argue, the obligation – to shop for services. Under the contract, as approved by the S.E.C. and this Commission, Hope must make an affirmative choice to procure services from its affiliate. But Dominion has not given Hope the resources or actual responsibility to make that choice. According to Hope's answers in Schedule SJR-2, Hope has failed to exercise any reasonable level of oversight or take any responsibility for these services. It has never solicited bids; it has never even tried to find out if anyone else could provide the service or what it might cost; its annual "selection" of services is made by executives in Dominion, not by anyone who is involved in Hope's day-to-day operations. <u>Incredibly, those executives are actually employees of the Service Company itself.</u> Hope does not even get meaningful invoices for these services – it simply receives summaries of charges by broad category, with no supporting detail whatsoever. In short, Hope has done nothing to determine if it is getting reasonably priced, efficiently provided services from Dominion. So I am proposing an adjustment that at least puts Hope on par – in just one service area – with comparable utilities.

Alternate Adjustment to Customer Costs: Six Sigma Improvements

Q. If the Commission rejects your adjustment to account 903, should it just accept Hope's going-level claim for that account?

A. No, it should not. While I strongly believe that the Commission should adopt my adjustment, if it does not do so, then there are four adjustments that should be made to Hope's going-level claim for account 903. These adjustments are required to reflect known and measurable changes in those costs that will occur during 2005, as a result of Dominion's Six Sigma program.

Q. Before you describe those adjustments, what is Six Sigma?

A. Six Sigma is a process by which companies seek to improve various aspects of their operations. The key to Six Sigma is that it requires measurement of the impacts of process improvement; that is, data are required to actually measure any claimed improvements. Originally, Six Sigma was developed to eliminate defects in manufacturing, but it has been modified to apply to non-manufacturing operations as well.