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D.T.E. 97-112

Petition of Colonial Gas Company requesting approval from the Department of the recovery of lost margins resulting from Demand Side Management Programs for the period May 1996 through April 1997.

APPEARANCES: Timothy Clark, Esq.

Bruce Glendening, Esq.

40 Market Street

Lowell, Massachusetts 01852

-and-

Jeffrey Jones, Esq.

Palmer and Dodge, L.L.P.

One Beacon Street

Boston, Massachusetts 02108

FOR: COLONIAL GAS COMPANY

Petitioner

Thomas F. Reilly, Attorney General

By: Rebeca Perez

James Stetson

Assistant Attorneys General

200 Portland Street

Boston, Massachusetts 02114

Intervenor

Paul Dexter, Esq.

LeBoeuf, Lamb, Greene & MacRae

260 Franklin Street

Boston, Massachusetts 02110

FOR: BAY STATE GAS COMPANY

Intervenor

Emmett Lyne, Esq.

Eric Krathwohl, Esq.

Rich, May, Bilodeau & Flaherty, P.C.

294 Washington Street

Boston, Massachusetts 02108

FOR: FALL RIVER GAS COMPANY

Intervenor

James Avery, Esq.

Emmett Lyne, Esq.

Rich, May, Bilodeau & Flaherty, P.C.

294 Washington Street

Boston, Massachusetts 02108

FOR: THE BERKSHIRE GAS COMPANY

Intervenor

John Cope-Flanagan, Esq.

Com/Energy Services Corporation

One Main Street, P.O. Box 9150

Cambridge, MA 02142

FOR: COMMONWEALTH GAS COMPANY

Intervenor

Thomas O'Neill, Esq.

Boston Gas Company

One Beacon Street, 34th floor

Boston, Massachusetts 02108

FOR: BOSTON GAS COMPANY

Limited Participant

Erica Tarpey, Esq.

LeBoeuf, Lamb, Greene & MacRae, L.L.P.

260 Franklin Street

Boston, Massachusetts 02110

FOR: FITCHBURG GAS AND ELECTRIC LIGHT COMPANY

Limited Participant

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I. INTRODUCTION

On December 19, 1997, Colonial Gas Company ("Company" or "Colonial") filed a proposal with the Department of Telecommunications and Energy ("Department") for the recovery of lost base revenue ("LBR") (also referred to as lost margins),[(1)] carrying costs and incentives for the period May 1996 through April 1997 associated with its demand-side management ("DSM") programs. Pursuant to notice duly issued, the Department conducted a hearing on March 10, 1998.

In addition to the LBR issues specific to Colonial, the Department determined it appropriate to investigate the time period for the recovery of LBR by Colonial Gas Company and other local distribution companies ("LDCs") subject to the Department's jurisdiction. On May 8, 1998, the Department issued a second notice on this issue and conducted a procedural conference on May 28, 1998. The Attorney General filed notice of intervention. In addition, the Department granted full intervenor status to Bay State Gas Company, Fall River Gas Company, the Berkshire Gas Company, and Commonwealth Gas Company. The Department granted limited participant status to Boston Gas Company and Fitchburg Gas and Electric Light Company. On September 16, 1998, the Department conducted a second hearing. The Company presented two witnesses, Nickolas Stavropoulos, Colonial's Chief Financial Officer and John L. Griffin, Colonial's Vice President of Rates. The Company also presented Matthew P. O'Loughlin, principal with the Brattle Group, to testify on the appropriate length of time a LDC may recover LBR.[(2)] The evidentiary record consists of 24 Company exhibits, 24 Attorney General exhibits and 17 Department exhibits. The Company responded to six record requests by the Attorney General and four record requests by the Department.

In Sections II and III of this Order we address Colonial's DSM impact evaluations and the Company's resulting LBR. Section IV addresses the appropriate method and time period

for recovery of LBR by Colonial as well as other LDCs subject to the Department's jurisdiction.

II. STANDARD OF REVIEW FOR IMPACT EVALUATIONS

In evaluating savings estimates from gas DSM programs, the Department will draw on its experience with electric DSM programs. Bay State Gas Company, D.P.U. 96-98,

at 1 (1997). The Department has found that many estimates of savings that are not actually measured have been biased upward substantially, and has therefore required companies to measure savings using impact evaluations. Massachusetts Electric Company,

D.P.U. 92-217-B, at 4-5 (1994) ("MECo"). The Department has identified and approved a wide variety of techniques for evaluating savings estimates. See, for example, MECo at 7-16, 35-38, 47-51, 68-74. However, the Department has found many cases where appropriate techniques have not been applied or have been misapplied to produce savings estimates that are biased upward or downward. See, for example, MECo at 5; Boston Edison Company, D.P.U. 96-1-CC, at 3-4, 9-12, 21-22, 24 (1996). Recognizing that obtaining more precise savings estimates has a cost, the Department directed companies to seek increased precision to the extent that the marginal value of more precise estimates exceeds the marginal cost of obtaining the additional precision. MECo at 5.

In MECo the Department introduced a standard of review to be applied to impact evaluations.[(3)] The Department has used the same standard for gas DSM evaluations: in order for a company's DSM savings estimates to be accepted, the company must demonstrate that its impact evaluations are reviewable, appropriate, and reliable. Bay State Gas Company,

D.P.U. 96-98, at 2, citing MECo at 4-6 (1977). An impact evaluation is considered reviewable if it is complete, clearly presented, and contains a summary that sufficiently explains all assumptions and data presented. MECo, at 4-6. An impact evaluation is considered appropriate if evaluation techniques selected are reasonable given the characteristics of a particular DSM program, the company's resources, and the available methods for determining demand and energy savings estimates. Id. Finally, an impact evaluation is considered reliable if the savings estimates included in the evaluation are unbiased and are measured to a sufficient level of precision, again, given the characteristics of a particular DSM program, the company's resources, and the available methods for determining demand and energy savings estimates. Id.

In Boston Gas Company, D.P.U. 94-15 (1995)("D.P.U. 94-15"), the Department ordered LDCs, when petitioning for the recovery of LBR and incentives from DSM programs, to develop energy savings estimates for their residential and multifamily programs using the Gas Evaluation and Monitoring Study ("GEMS")[(4),(5)] method, subject to certain conditions.

See D.P.U. 94-15, at 52-54.

III. THE COMPANY'S DSM IMPACT EVALUATIONS

Colonial requests the recovery of LBR and carrying costs associated with its Residential and Commercial & Industrial ("C&I") DSM programs of $1,013,240 for the period May 1996 through April 1997 (Exhs. C-3, C-9). The Company plans to recover these amounts over a twelve month period beginning November 1, 1997 (Exh. C-4, at 1).[(6)] The following sections break down this total amount according to customer classes.

A. Residential Programs

1. Description

Colonial stated that it used the GEMS method, approved in D.P.U. 94-15, to calculate the savings per thousand cubic feet ("Mcf") for its residential DSM programs (Exhs. C-1,

at 1; C-2). The Company calculated total savings for its residential DSM programs of 183,227 Mcf for the period May 1996 through April 1997 (Exh. C-3, at 52). The Company stated that it calculated the residential program's lost margin amounts based upon the Mcf savings it determined pursuant to the GEMS method (Exhs. C-1, at 1). Based upon these calculations, the Company requests the recovery of LBR associated with its residential DSM program of $640,701 plus $75,068 of carrying costs totaling $715,769 for the period May 1996 through April 1997 (Exhs. C-2, at 1; C-3).

2. Analysis and Findings

The Department has reviewed the Company's savings estimates associated with its residential DSM programs. The Department finds that the Company appropriately applied the GEMS Method to calculate its energy savings estimates. Accordingly, the Department finds the Company's savings estimates for its residential program to be reliable, reviewable, and appropriate, and hereby accepts them.

B. C&I Programs

The Company stated that it used the impact evaluation process, approved in Colonial Gas Company, DPU 96-31 (1996), to calculate the Mcf savings and the lost margin amounts for both its small and medium C&I DSM programs (Exh. C-4, at 63). In this filing, for the period May 1996 through April 1997, Colonial estimated total net savings for both of its C&I DSM programs to be 90,497 Mcf (Exh. C-9). Based upon these savings estimates, the Company requests the recovery of LBR associated with its C&I DSM program of $262,009 plus $35,462 of carrying costs totaling $297,471 (Exh. C-4, at 6; C-9). As described below, Colonial used different methods to determine the savings of its small C&I Program and its medium C&I Program.

1. Description

a. Small C&I Program Savings Estimates

The Company noted that thirteen gas savings measures are offered through the small C&I program and customers receive full subsidy for installations of recommended measures

(Exh. C-4 at 64). Customers taking service under rate schedules G-41 and G-51 are eligible for this program (id.).

The Company indicated that in order to calculate net Mcf savings for each measure, it discounted the annualized gross savings figure for each measure by a free rider estimate and a persistence factor (id. at 65). The Company defined free riders as those customers who planned to install a measure on their own (the same amount or more, sooner or at the same time) prior to program participation (id.). Colonial stated that persistence factors account for measures that are still installed and operating properly (id.). The Company stated that it developed these free rider estimates and persistence factors in Colonial Gas Company, D.P.U. 96-31 (1996) as part of its impact evaluation analysis (id.).

The Company's impact evaluation study results indicated that the overall realization rate[(7)] for Small C&I Program is 107% (id. at 64). Colonial stated that this meant gross savings estimated through the impact evaluation were 107% of the savings expected using Colonial's engineering data for this program (id.). The Company explained that, to calculate total program savings, it multiplied engineering savings estimates for the entire population of program participants by the realization rate (id.).

The Company stated that the total net savings attributable to the Small C&I Program in Lowell and Cape Cod Divisions for May 1996 through April 1997 amounted to 29,984 Mcf (Exh. C-6). The Company multiplied the savings times the base rates to arrive at the LBR of $138,497 (Exh. C-4, at 69 and Exh. C-9). The Company also requested $19,444 in carrying costs for its Small C&I Program (Exh. C-9, at 294).

b. Medium C&I Program Savings Estimates

The Company stated that customers on rate classes G-42 and G-52 are eligible for its Medium C&I Program (Exh. C-4 at 65). The Company noted that twenty seven gas savings measures are offered through the Medium C&I Program (id.). Colonial stated that it used "Market Manager," an energy audit and modeling software package, developed by Synergic Resource Corporation, to identify appropriate gas savings measures, and the associated cost and estimated savings for each customer (id. at 66).

Unlike the use of engineering estimates relied on by the Company to calculate savings for the Small C&I Program, the Company derived initial savings estimates by using

customer-specific facility audit data for the Medium C&I Program (id.). Colonial stated that for each customer, Market Manager created an energy model that simulated the energy use of a facility prior to the installation of any measure (id.). Following this, the Company added savings measures to the model and estimated annualized Mcf savings for

each customer (id.). In order to calculate the gross annual Mcf savings for each customer, the Company subtracted the estimated gas usage for a facility with measure installations from the facility's existing gas usage as calculated (id. at 67).

The Company claimed that the total net savings attributable to the Medium C&I Program in Lowell and Cape Cod Divisions for May 1996 through April 1997 was 60,513 Mcf (Exh. C-9). The Company used this total net savings figure as input into its LBR calculations (Exh. C-5, at 7). The Company requested $123,511 in LBR and $16,017 in carrying costs for its Medium C&I Program (Exh. C-9, at 296).

C. Analysis and Findings

The Department notes that Colonial used the same evaluation methods approved in D.P.U. 96-31 to determine total savings for its small and medium C&I DSM programs. The Department's review of the record shows that the Company's impact evaluations for C&I DSM programs are complete and clearly presented, with all data and assumptions sufficiently explained. Accordingly, the Department finds that the Company's impact evaluations for its C&I DSM programs are reviewable. Furthermore, upon review of the record in this case, the Department finds that the evaluation techniques Colonial used for its C&I programs are reasonable and are consistent with previous Department Orders. Therefore, we find that the Company's impact evaluations for Colonial's C&I programs are appropriate.

The Department notes that the savings estimates for Colonial's C&I programs are based on (1) engineering savings estimates multiplied by the realization rate for Small C&I Customers and (2) customer-specific Market Manager reports for Medium C&I Customers. Based on our review of the filing, we find that these estimates are sufficiently unbiased and are measured to a sufficient level of precision. Accordingly, the Department finds that the Company's savings estimates for C&I programs are reliable.

IV. LOST BASE REVENUE

A. Background

The Department first addressed the issue of LBR recovery in Integrated Resource Management, D.P.U. 86-36-F (1988). In that Order, the Department stated that if an electric company "demonstrates that the successful performance of its [DSM] programs will result in sales erosion that adversely affects revenues in a significant, quantifiable way, the Department would entertain specific proposals for appropriate adjustments" in the company's rates. Id. at 35-36. The Department later distinguished between the short term and long-term LBR effects of DSM implementation. Western Massachusetts Electric Company, D.P.U. 89-260,

at 106 (1990). The Department stated that, from a short-term perspective (e.g., less than one year), DSM will not result in base-rate cost savings that would reduce the amount of

LBR a company should recover. However, from a long-term perspective, DSM will result in base-rate cost savings that should reduce a company's LBR. Id.

In concert with these policies, beginning with Eastern Edison Company, D.P.U. 94-4-CC (1994) and continuing through Boston Edison Company, D.P.U. 95-1-CC (1995); Cambridge Electric Light Company and Commonwealth Electric Light Company, D.P.U. 95-2/3-CC (1995); Fitchburg Gas and Electric Light Company, D.P.U. 95-5-CC (1995); and Western Massachusetts Electric Company, D.P.U. 95-8-CC (Phase II) (1995), the Department investigated various alternative LBR recovery methods to determine the extent to which they would reflect the fact that a company's implementation of DSM programs would, over time, permit a reduction in the cost of providing electric service to ratepayers. See, e.g., D.P.U. 94-4-CC at 41. These investigations also were motivated by the fact that, because of competitive pressures on electric companies to mitigate rate increases, electric companies were not filing general rate cases at regular and brief intervals. As a result, the likelihood increased that the LBR portion of companies' DSM budgets was increasing to levels unanticipated when the Department issued its decision in D.P.U. 86-36-F.[(8)] In investigating these alternative methods, the Department sought to determine the extent to which the methods would (1) allow for the determination of net revenue lost as a result of DSM implementation: i.e., a company's base revenue that is truly lost after taking into account the opportunities to reduce the cost of electric service; (2) provide sufficient incentive to the Company's management to reduce costs and to operate the Company's resources as efficiently as possible; and (3) be consistent with Department precedent, potentially applicable to all electric companies, and relatively easy to administer. See D.P.U. 94-4-CC at 40-41. The Department found that the Rolling Period Method, described below, best satisfied these objectives. D.P.U. 95-8-CC (Phase II);

D.P.U. 95-5-CC;D.P.U. 95-2/3-CC; D.P.U. 95-1-CC; D.P.U. 94-4-CC.

In the Rolling Period Method, LBR associated with a specific year of DSM implementation would be recovered for a period equal to the average length of time between each of a company's last four rate cases, or until new rates take effect subsequent to a new base rate proceeding. First, the Department found that, because the Rolling Period Method allows for the recovery of LBR for a period equal to the average, historic time span between rate cases, it provides a reasonable approximation of an electric company's costs that would be sought in a rate case proceeding and, thus, represents a reasonable approximation of the extent to which the company's implementation of DSM programs will, over time, permit the company to reduce the costs of providing electric service to its ratepayers. D.P.U. 94-4-CC at 42 (1994). Second, the Department found that the Rolling Period Method will provide companies with a direct and consistent incentive to reduce costs and improve the efficiency of its operations. Id. at 43. Finally, the Department found that this method is consistent with precedent, could be applied to all electric companies, and would be relatively simple to administer. Id. The alternative methods the Department considered were (1) an "avoided cost" method; (2) a "return on equity cap" method; and (3) a "single issue rate case" method. The methods are summarized below.

In the proposed "avoided cost" method, LBR would be calculated by determining a gross LBR amount and subtracting the costs that have been reduced or otherwise avoided as a result of the implementation of DSM. The Department found that with good information, the "avoided cost" method could provide an accurate determination of the effect of DSM energy and capacity savings on a company's bottom line (i.e., the reduction in revenue minus the reduction in costs). D.P.U. 94-4-CC at 41. However, because of the administrative burden that this method would impose upon a company, as well as the lack of reliable data, the Department found that a company could not apply the "avoided cost" method with a reasonable level of statistical confidence. Id. Therefore, the Department rejected the use of this method. D.P.U. 95-1-CC at 65-66; D.P.U. 94-4-CC at 41.

In the proposed "return on equity ("ROE") cap" method, the level of LBR recovery would be based on whether a company earned its allowed ROE, as specified in its most recent base rate case proceeding. Under this method, a company would be precluded from recovering any LBR in a year during which the company exceeded its allowed ROE. The Department found that the "ROE cap" method may create a disincentive for a company to advance its competitive position through cost reductions and implementation of other operational efficiencies. D.P.U. 94-4-CC at 41. The Department further found it inappropriate to assume that an increase in earnings caused by a potentially broad range of factors is associated in any way with the reduction in costs due to DSM implementation. Id. Therefore, the Department rejected the use of this method. D.P.U. 95-1-CC at 67; D.P.U. 94-4-CC at 42.

In the proposed "single-issue rate case" method, a company would periodically file a rate case in order to adjust its rates to account for changes in sales levels from the levels approved in the company's most recent rate case. D.P.U. 95-8-CC (Phase II) at 34-36. The Department found that although this method might produce rates that capture the effects of DSM programs and measures in rates based on a new test year sales level, so too would it capture the effects of a multiplicity of other factors unrelated or only indirectly related to DSM. Id. at 45. Therefore, the Department rejected the use of this method. Id. at 46.

As for LDCs, the Department did not specifically investigate the appropriate length of time for LDCs to collect LBR. However, the Department informed all LDCs that we (1) would revisit the need for recovery of LBR, and the means of verifying claimed LBR and (2) intended to examine LBR recovery and incentives in the context of the overall changes to the gas industry and the DSM marketplace. Boston Gas Company, D.P.U. 94-15, at 61, 68 (1995). Finally, on May 8, 1998, the Department issued notice in this proceeding of its intent to investigate alternative methods for the calculation of LBR recovery for all LDCs in the Commonwealth.

B. The Company's Proposal

As noted, the Company does not propose to use the Rolling Period Method to calculate LBR recovery. Instead, the Company is proposing to recover LBR for those DSM measures installed from the beginning of its DSM programs through April, 1997 (Exh. C-

12, at 11). The Company presented evidence that the average time between Colonial's last four rate cases is four years (Exh. AG-2-18; Tr. 3, at 168-169).[9]

The Company argued that LBR is a legitimate cost associated with DSM programs and recovery of LBR over the lives of the measures installed was a necessary prerequisite for gas utilities to pursue cost-effective DSM programs aggressively (Exh. C-16, at 2-3). Colonial noted that the Department has attempted to determine "net" LBR, defined as gross LBR less avoided costs, but there are difficulties in quantifying the cost savings that should be netted from the gross LBR (id. at 3).

The Company argued that gas utilities are significantly different from electric utilities in at least two ways and therefore the LBR recovery period for gas utilities would have to be at least three years longer than that for electric utilities (id. at 3-4). First, the Company claimed that the loss in revenue effects of gas DSM programs are longer-lived because, on average, the life of gas DSM measures is longer than the life of electric DSM measures

(Exhs. C-16, at 4; C-18). To prove this, Colonial developed "composite average program measure lives" for both utility types by weighting the individual measure lives by their "associated energy savings" (Exhs. C-16, at 17; C-18). The Company compared average measure lives from three electric companies and five LDCs (Exh. C-18).[10] The Company's calculation of measure lives yielded 16.1 years for gas utilities and 11.7 years for electric utilities (id.).

Second, Colonial claimed that a comparison of long-term cost trends indicated that the change in operating costs per increment/decrement in throughput is uniformly higher for Massachusetts electric utilities than for gas utilities which, in turn, affects the length of time over which LBR should be recovered (Exh. C-16, at 3-4). The Company included the following electric utilities in this analysis: Boston Edison, Commonwealth Electric, Eastern Edison, Massachusetts Electric and Western Massachusetts Electric. Gas utilities included are Bay State Gas, Boston Gas, Colonial Gas and Commonwealth Gas (id. at 21).

The Company developed a financial model which calculated, for both gas and electric utilities, the length of time for which the present value of the gross LBR stream associated with a single unit of conserved energy (i.e., one kilowatt-hour ("KWH") or one dekatherm ("Dth")) most closely approximates the present value of the conserved unit's net LBR stream (id. at 18). The Company developed parameters for the gross and net LBR values based on historical data for the major Massachusetts electric and gas utilities (id. at 21). For this model, the Company set the gross LBR values equal to the weighted-average of the utilities' 1996 non-fuel distribution margins (id.).[11]

To develop a net LBR stream, Colonial developed a range of avoided operating cost values based on an examination of cost and sales data from the Commonwealth's major electric and gas utilities for the period 1983-1996 (Exh. C-16, at 21). The Company indicated that the total base year avoided operating and maintenance ("O&M") and

transmission and distribution ("T&D") value ranged from $0.0139 per KWH to $0.0278 per KWH for the electric utilities and from $0.576 per Dth to $1.151 per Dth for the gas utilities (id.).[(12),(13)] The Company then inflated these values to nominal values using a long run inflation forecast (id.). Finally, the Company netted these avoided cost values from the respective gross LBR values to create corresponding net LBR streams (id.). Colonial's estimates indicated that for both utility types, the net LBR margin per unit decreases over time within the model (id.).

Based on these derived net LBR values described above, the Company calculated the present value of the lifetime gross LBR stream at an assumed discount rate of 10% and a measure life of 12 years for electric and 16 years for gas (Exhs. C-16, at 21-22; C-20). Similarly, the Company calculated present values of the net LBR stream for periods ending each year for the duration of the measure life (Exh. C-20). Using these results, the Company identified for each utility type the period for which the present value of the gross LBR stream most closely approximated the present value of the lifetime net LBR stream (Exh. C-16,

at 22). The Company determined that the periods for which the gross LBR stream equates to the net LBR stream is three to six years for electric and six to ten years for gas (Exhs. C-16,

at 22; C-20, at 1-2).[(14)]

The Company concluded that a "three year rolling period method" for the recovery of LBR used in the electric industry should not be adopted for the gas industry because it would be unfair, financially harmful and inappropriately short for the gas industry

(Exh. C-12, at 1, 2). Instead, the Company stated that if new rules regarding any change to the timing of LBR recovery are to be implemented, (1) the recovery should be at least six to ten years long, and (2) new rules should take effect on a prospective basis (Exh. C-12 at 8, 12; Tr. 3 at 40-41).[(15)]

C. Positions of the Parties

1. The Attorney General

The Attorney General contends that the Department has set an initial requirement for a Company to qualify for recovery of LBR; namely, the LDC must demonstrate that the implementation of DSM programs has resulted in "sales erosion that adversely affects revenue" (Attorney General Brief at 3, citing Colonial Gas Company, D.P.U. 91-150 at 69 (1992)). The Attorney General argues that during the period in question, 1993-1997, Colonial has experienced a seven percent growth in sales and a twelve percent growth in revenues

(id. at 4). Thus, the Attorney General claims that Colonial can not substantiate its assertion that foregone sales from implementing DSM programs have adversely affected revenues and require recovery of LBR (id.).

Further, the Attorney General argues that LBR should not continue because Colonial has earned a return on common stock equity in excess of its allowed return (id.). The Attorney General claims that over the last five years, the Company's average earned return on common stock equity averaged 13.36 percent and its return on rate base averaged 11.27 percent, both of which exceed the Company's 11.19 percent cost of capital (id.). The Attorney General concludes that these statistics show that Colonial is clearly able to earn its cost of equity capital without LBR recovery (id. at 5, citing Exh. AG-2-2 and RR-AG-3).

2. Colonial Gas

The Company contends that this proceeding should be nothing more than the fourth in a series of "compliance filings" relative to a review of its LBR calculations for the period in question (Company Brief at 1). Colonial argues that it has justifiably relied on the previous method approved by the Department, and any change in LBR recovery at this time would constitute an unfair and retroactive rulemaking on the part of the Department (id. at 13, 17). Furthermore, Colonial contends that the Department never placed Colonial on notice that the Department intended to consider fundamental issues of Department policy in Colonial's "routine compliance filing" (id. at 2). Colonial asserts that the Department adopted rules assuring full LBR recovery, and also approved financial incentives based on the success of Colonial's DSM programs (id. at 14).

The Company contends that it has relied on the existing LBR recovery method and any change at this point would undermine Colonial's legitimate expectations of how the Department evaluates LBR (id. at 2). Colonial states that it has invested $18 million in DSM measures relying on the rules established by the Department at the outset of such programs

(id. at 13). The Company maintains these Department rules assured companies that they would not be subject to significant financial detriment as a result of revenues lost through successful DSM programs and allowed both gas and electric companies full LBR recovery as well as additional financial incentives (id. at 13-14). Colonial asserts that because the impact of DSM programs on revenues has become significant, the Department's promise of continued LBR recovery is necessary (id. at 15). The Company contends that based on Department actions in the past, the Company is justified in expecting to recover LBR from all historically installed measures (id. at 17).

The Company asserts that the Department must adhere to the standard of reasoned consistency in its decision-making and has no basis on the record of this case to deviate from prior Department decisions governing recovery of LBR (id.). The Company claims the method proposed in this case is the same method proposed in all of its previous compliance filings (id. at 18). The Company maintains that any change in LBR recovery

that applies to DSM measures installed some years ago would constitute unfair retroactive rulemaking

(id. at 17).

The Company contends that the three year rolling period recovery method adopted for electric utilities should not apply to gas companies because rules adopted for electric utilities cannot automatically be transferred to the gas industry (id. at 18). The Company argues that the Department has taken several different approaches to the measurement and recovery of LBR over the years and has essentially permitted companies full recovery of gross LBR (id.). The Company contends that the Department permitted full recovery of gross LBR because it determined that little or no costs could be assumed to be avoided as a result of the implementation of DSM measures (id.).

Lastly, the Company asserts that the Department should not adopt a new LBR policy that would encourage companies to file a rate case more often than they otherwise would

(id. at 22). In addition, the Company claims that the Department has rejected "single issue" rate cases in the past. Therefore, for the Department to adopt a new LBR recovery method that would encourage the filing of a rate case because of one extraordinary cost item would be inconsistent with this Department policy (id. at 23). The Company further maintains that filing a rate case would be an unfair remedy for Colonial because the Department's prior policy clearly permitted companies to recover LBR. Moreover, Colonial claims that rate cases are costly, resource intensive, and negative from a public relations and growth point of view; and changing rules in mid-stream is bad public policy for the Department (id.).

3. The Other LDCs

The Berkshire Gas Company, Commonwealth Gas Company, and Fall River Gas Company ("LDCs") support the positions asserted by Colonial Gas Company

(LDCs' Brief at 1). Furthermore, the LDCs assert that the current LBR recovery system allows for financial stability by (1) providing financial benefits to customers; (2) mitigating the need for frequent base rate increases; and (3) improving utilities' credit and bond ratings, thereby decreasing the cost of capital which ultimately decreases costs for a company's customers (id. at 10).

According to the LDCs, LBR is being phased-out as LDCs transition from DSM retrofit programs to market transformation programs (id.). The LDCs also contend that they have aggressively implemented DSM, are not seeking LBR on new market transformation programs, and have phased out shareholder incentives because of the Department's LBR recovery policy (id. at 11).[(16)]

The LDCs argue that any changes to the LBR recovery policy, such as the adoption of a rolling period method, should be made only on a prospective basis and should reflect the

significant differences between gas and electric DSM (id. at 13). The LDCs assert that to mitigate any potential negative short term results from a change in LBR recovery policy, any changes should apply only to DSM installations occurring after the effective date of the order, to take effect in the November 1999 local distribution access charge/cost of gas adjustment charge filing cycle (id.). Further, the LDCs state that while electric companies have historically recovered substantial shareholder incentives, LDCs are not in a position to increase such incentives because they have foregone substantial shareholder incentives in their most recent settlement agreements (id. at 14).[(17)]

D. Analysis and Findings

We will first address the issues of notice, reasoned consistency and retroactive rulemaking raised by the Company and the LDCs. We will next address the the appropriate method to be used in the calculation of LBR to be recovered by the LDCs and the effective date of the implementation of any alternative method that may be adopted.

1. Notice

Colonial has been on notice from its first LBR case that the Department would review the method for calculating LBR each time the Company submits its request to recover LBR. Colonial Gas Company, D.P.U. 91-150, at 70 (1992). The Department later put all LDCs on notice that it (1) would revisit the need for recovery of LBR, and the means of verifying claimed LBR and (2) intended to examine LBR recovery and incentives in the context of the overall changes to the gas industry and the DSM marketplace. Boston Gas Company,

D.P.U. 94-15, at 61, 68 (1995). In a series of orders beginning in 1994, the Department established the "Rolling Period Method," for LBR recovery for electric companies. Eastern Edison Company, D.P.U. 94-4-CC (1994); Boston Edison Company, D.P.U. 95-1-CC (1995); Cambridge Electric Light Company and Commonwealth Electric Light Company, D.P.U. 95-2/3-CC (1995); Fitchburg Gas and Electric Light Company, D.P.U. 95-5-CC (1995); and Western Massachusetts Electric Company, D.P.U. 95-8-CC (Phase II) (1995). Those investigations concerned cost recovery mechanisms that are consistent with those used in rate proceedings for certain components of an electric or gas utility's cost of service.

See D.P.U. 95-1-CC at 68. Therefore, managers of LDCs should have been aware of the Department's treatment of these LBR cost recovery mechanisms. Finally, on May 8, 1998, the Department issued notice of its intent to investigate alternative methods for calculation of LBR recovery for all LDCs in this proceeding. Accordingly, the Department finds that the LDCs have had adequate notice, and a full opportunity in this proceeding to present evidence concerning alternative methods of recovering LBR.

The Department would also like to clarify the Company's incorrect characterization of its LBR filing as a "compliance filing." In D.P.U. 94-15, the Department approved a method of calculating energy savings associated with residential DSM programs, the results of

which are subsequently used to determine LBR. However, the Department did not pre-approve a fixed method for calculating LBR. Instead, the Department reviews a company's proposed method for calculating LBR each time a company submits a request to recover LBR.[18] See D.P.U. 91-150, at 69. In each of those proceedings, the Department has the authority to investigate the length of time for a company's recovery of LBR.

2. Reasoned Consistency

The Company and the LDCs argue that any change the Department orders regarding the length of time a LDC may collect lost revenues would be contrary to the doctrine of "reasoned consistency." A party to a proceeding before a regulatory agency such as the Department has a right to expect and obtain reasoned consistency in the agency's decisions, and any change from an established pattern of conduct must be explained. Boston Gas Company v. Department of Public Utilities, 367 Mass 92, 104, 105 (1975); Robinson v. Department of Public Utilities, 416 Mass. 668, 673 (1993).

In this proceeding, we are investigating the need for an alternative method of calculating LBR that focuses upon the appropriate length of time an LDC should collect LBR. This review is consistent with the Department's previous statement that it would revisit the need for recovery of LBR, and the means for verifying claimed LBR. Boston Gas Company,

D.P.U. 94-15, at 61, 68 (1995). In presenting their case, the LDCs took into consideration prior Department policy and precedent on LBR recovery methods for LDCs and electric companies. In Section IV.D. 4 below, after considering the entire record, we determine the appropriate length of time LDCs can recover LBR and explain our reasons for adopting the Rolling Period Method.

We note that Colonial requests approval to collect $1,013,240 in LBR and carrying costs for the period May 1996 through April 1997.[19] This amount represents a significant increase compared to the $865,594 of LBR, incentives and carrying costs approved in Colonial Gas Company, D.P.U. 96-95 (1997) for the period May 1995 through April 1996.[20] Although only the appropriate amount of LBR recovery for Colonial is at issue in this proceeding, the Department is concerned that increasing amounts of LBR recovery by all LDCs could adversely affect the DSM services for which LDC ratepayers have been paying. The fact that all LDCs have been given adequate notice of this investigation and the increasing amount of money Colonial seeks to collect for LBR factored into the Department's decision to investigate alternative methods of calculating LBR recovery for all LDCs. See Western Massachusetts Electric Company, D.P.U. 95-8-CC at 44 (1995) (one of the Department's reasons for investigating the length of time electric utilities collected LBR was the increase in magnitude of the LBR portion of conservation charges to unanticipated levels).

3. Retroactive Rulemaking

The Company and LDCs argue that any change in the recovery method for LBR would constitute unfair and retroactive rulemaking. The Department reviews the method for calculating LBR each time the LDC submits its request to recover LBR. See Colonial Gas Company, D.P.U. 91-50, at 70 (1992). Thus, the method for recovery of LBR is susceptible to re-evaluation and changes in any proceeding. In this proceeding, we are examining alternative methods for LBR recovery in the context of (1) the overall changes to the gas industry; (2) the DSM marketplace, and (3) Department precedent on LBR. See Boston Gas Company, D.P.U. 94-15, at 61, 68 (1995). As discussed below, a sufficient record has been developed in this case to adopt a different recovery method and we find it reasonable and appropriate to do so. Evolving policy by the Department for the future recovery of LBR is not retroactive rulemaking; instead, the Department is revising its stated LBR policy to be consistent with present and future LDC DSM programs. Past Department precedent on the matter does not preclude the Department's changing its policy on a going-forward basis if there is a sufficient record to support the change. As discussed below, we find that a change in policy on LBR recovery is justified both in logic and upon the record presented.

4. Method of LBR Calculation

In evaluating gas savings associated with DSM programs, the Department has drawn on its experience with electric DSM programs. See Bay State Gas Company, D.P.U. 96-98 at 1 (1997). In this proceeding, the Department reviews the Company's proposal and the Attorney General's arguments regarding LBR on the basis of the Department's established LBR policy objectives to: (1) allow for the determination of net revenue lost as a result of DSM implementation, i.e., a company's base revenue that is truly lost after taking into account the opportunities to reduce the cost of service; (2) provide sufficient incentive to the Company's management to reduce costs and to operate the Company's resources as efficiently as possible; and (3) be consistent with Department precedent, applicable to all companies, and relatively easy to administer (see Section IV.A, above).

The Department first addresses the Attorney General's argument that the Company is not entitled to recovery of LBR because it failed to meet the Department's requirements for LBR recovery. As stated in Section IV.C.1, the Attorney General's argument is based on two points: (1) the Company experienced a growth in sales and revenue during the period for which it is seeking LBR recovery; and (2) the Company's return on equity during the same period exceeded its allowed return. The Department, however, has previously found that an adjustment for LBR is appropriate even when a company experiences growth in sales and revenue. In D.P.U. 89-260, at 104, the Department stated that

historical test year ratemaking assumes a direct relationship between costs and sales, i.e., it assumes that a growth in sales is accompanied by increased costs. As a result, increased revenues resulting from increased sales are assumed to be necessary to cover these increased costs.

The Department's LBR policy should not discourage a company from increasing the number of customers on its distribution system and ultimately spreading the cost to serve over a larger customer base. Therefore, the Department rejects the Attorney General's argument regarding increased sales and costs.

The second point raised by the Attorney General is, in essence, a request to have the Department adopt the ROE Cap Method, which the Department has previously investigated and rejected. As stated in Section IV.A, the Department has stated that, by tying LBR recovery to a company's ROE, the ROE Cap method may create a disincentive for a company to advance its competitive position through cost reductions and implementation of other operational efficiencies. In addition, the Department found that it would be inappropriate to assume that an increase in earnings caused by a potentially broad range of factors is associated in any way with the reduction in costs due to DSM implementation. D.P.U. 94-4-CC at 42. In this proceeding, the Department finds that the Attorney General has not provided convincing evidence or persuasive argument to warrant the Department changing our position regarding the ROE method. Therefore, the Department rejects the Attorney General's proposal.

The Department now addresses the Company's proposal.[(21)] As an initial matter, contrary to Colonial's assertion, the Department's decision to permit gas companies full recovery of gross LBR as opposed to net LBR[(22)] was not based on a conclusion that "little or no costs can be avoided as a result of the implementation of DSM measures (Company Brief

at 18)." Instead, the Department allowed gas companies to recover gross LBR because of the difficulty in quantifying the amount of cost savings associated with the implementation of DSM programs.

The Company proposes that the recovery period of gas LBR should be at least three years longer than the recovery period allowed for electric utilities, for two reasons: (1) the change in operating costs per increment/decrement in throughput is uniformly lower for Massachusetts gas utilities than for electric; and (2) the average lives of gas DSM measures are longer than the lives of electric DSM measures.

The Company's assertion regarding lower DSM-related avoided costs for gas companies vis-a-vis electric companies is based on the results of a financial model that was intended to model the costs that gas and electric utilities might avoid as a result of DSM implementation.[(23)] In effect, the Company's proposal is a variation of the "avoided cost" method, which the Department has previously investigated and rejected. In D.P.U. 94-4-CC, the Department found that, with good information, the "avoided cost" method could provide an accurate determination of the effect of DSM energy and capacity savings on a company's bottom line (i.e., the reduction in revenue minus the reduction in costs). However, because of the administrative burden this method would impose upon a company, as well as the lack of good data, the Department found that a company would not be able to apply the "avoided cost" method with a reasonable level of statistical confidence. Id. Therefore, the Department rejected the use of this method. D.P.U. 95-1-CC at 65-66; D.P.U. 94-4-CC at 41. For similar reasons, our review of the analyses

conducted by the Company using this model in this proceeding leads us to the same conclusions.

Colonial used data from five electric utilities and four gas utilities to calculate gross LBR streams for the electric and gas industries in Massachusetts.[(24)] When the Company calculated net LBR streams that were to be representative of the electric and gas industries in Massachusetts respectively, Colonial used the same number of gas and electric companies to determine avoided operation and maintenance ("O&M") costs for each industry. However, Colonial did not use avoided transmission and distribution ("T&D") cost data from these same companies but instead relied on T&D avoided cost estimates from only one electric company and only two gas companies. There is nothing in this record to indicate that avoided cost data from two gas companies and only one electric company is representative of the gas and electric industries.

Moreover, in its analyses, the Company used two sets of gas-related avoided costs (Exh. C-24). One set was based on a ten-year period from 1987-1996 and the second set was based on a five-year period from 1992-1996. Colonial used the ten-year 1987-1996 data

-- the lower of the two avoided cost estimates -- instead of the more recent five-year data. Gas DSM programs did not exist prior to 1992 and, thus, no costs could have been avoided before then. Therefore, the Company's application of avoided costs for the period 1987-1992 is inappropriate. Colonial's selective use of the lower avoided costs resulted in a longer recovery period for gas LBR. In contrast, the use of the 1992-1996 avoided cost data yields a recovery period of four years as opposed to the six years proposed by Colonial.

Finally, the Company's financial model assumed that there are no base rate changes for a period of 12 years for the electric industry, and 16 years for the gas industry (Exh. C-20). This assumption does not mirror the actual industry experience in Massachusetts and is not based on record evidence. Colonial, for example, provided evidence that the average time between its last four rate cases is four years (see Exh. AG-2-18). Moreover, the Company presented no evidence on the average time between rate cases for other LDCs. For the above reasons, the Department rejects the Company's argument for lower DSM-related avoided costs for gas companies compared to electric companies.

The Company's assertion that the recovery period for gas LBR should be longer than the recovery period for electric LBR is also based on the results of Colonial's analysis of DSM measures offered by Massachusetts utilities. Those results show that measure lives for gas utilities are longer than for electric utilities. In particular, Colonial examined DSM measures offered by five gas utilities and three electric utilities and developed composite average program measure lives for both utility types. The Company's method produced an overall average program life of 16 years for gas utilities and 12 years for electric utilities.

Our review of the Company's analysis leads us to conclude that the results are not reliable. The Company examined data from only three out of seven electric companies.

Moreover, in the case of one of those companies, Colonial considered only the domestic hot water measures and excluded all other measures. The Company provided no evidence that the lives of measures it examined are representative of those in the electric industry in Massachusetts. Further, in calculating the average life for gas measures, the Company looked at the program measures offered by four out of the five gas utilities but, in the case of the fifth utility, Colonial's analysis included only the residential program. Based on the above analysis, the Department rejects the Company's proposal that a Rolling Period Method for gas utilities would necessitate a rolling period that would be at least three years longer than the equivalent period for electric utilities, or a total period of six to ten years.

Concerning the Company's argument that the Rolling Period Method cannot automatically be transferred to the gas industry, the Department has previously considered several alternative methods for LBR recovery and concluded that the Rolling Period Method is equal to the average, historic time span between a company's last four rate cases,[(25)] and is appropriate because it "provides a reasonable approximation of a company's costs that would be sought in a rate case proceeding (see § IV.A. above)." D.P.U. 94-4-CC at 42 (1994). The Department has also found that the Rolling Period Method is consistent with cost recovery mechanisms used in rate proceedings for certain components of a company's cost of service (e.g., the determination of recoverable rate case expense). See D.P.U. 95-1-CC at 68. We further find that the application of the Rolling Period Method is consistent with other general regulatory accounting methods used by the Department for both gas and electric companies, and is simple to administer. After review of the Company's proposal and considering the LBR policy objectives established in previous orders, we conclude that the appropriate method for LBR recovery for Colonial and all other LDCs is the Rolling Period Method. Accordingly, the Department will allow each LDC to recover LBR associated with each DSM implementation year for a period equal to the average time between each of its last four rate cases. The Rolling Period method of LBR recovery will apply to all DSM filings, including DSM settlement agreements, made by local distribution companies subject to the Department's jurisdiction, subsequent to the issuance of this Order.

Colonial shall recover LBR associated with its DSM programs for a period equal to the average time between each of its last four rate cases which is four years. The Department notes that its approval of the Rolling Period Method will not affect Colonial's recovery of LBR for the three-year period May 1996 through April 1999. However, Colonial's LBR calculations for the 12-month period beginning May 1, 1999 shall not include energy savings associated with DSM measures installed before May 1, 1995.

V. ORDER

Accordingly, after due notice, hearing and consideration, it is

ORDERED: That the savings estimates for Colonial's DSM measure installations for the period May 1996 through April 1997 are hereby approved; and it is

FURTHER ORDERED: That Colonial shall implement the Rolling Period Method, as discussed in Section IV.A., above, for the recovery of lost base revenue for the 12-month period beginning May 1, 1999; and it is

FURTHER ORDERED: That the Rolling Period Method of lost base revenue recovery shall apply to all DSM filings, including DSM settlement agreements, made by each of the local distribution companies subject to the Department's jurisdiction subsequent to the issuance of this Order.

By Order of the Department,

Janet Gail Besser, Chair

James Connelly, Commissioner

W. Robert Keating, Commissioner

Paul B. Vasington, Commissioner

Eugene J. Sullivan, Jr., Commissioner

Appeal as to matters of law from any final decision, order or ruling of the Commission may be taken to the Supreme Judicial Court by an aggrieved party in interest by the filing of a written petition praying that the Order of the Commission be modified or set aside in whole or in part.

Such petition for appeal shall be filed with the Secretary of the Commission within twenty days after the date of service of the decision, order or ruling of the Commission, or within such further time as the Commission may allow upon request filed prior to the expiration of twenty days after the date of service of said decision, order or ruling. Within ten days after such petition has been filed, the appealing party shall enter the appeal in the Supreme Judicial Court sitting in Suffolk County by filing a copy thereof with the Clerk of said Court. (Sec. 5, Chapter 25, G.L. Ter. Ed., as most recently amended by Chapter 485 of the Acts of 1971).

1. LBR or lost margins are defined as the non-gas-cost portion of a gas utility's base rates that is lost between rate cases as a result of reduced sales caused by the implementation of Demand Side Management programs. Boston Gas Company, D.P.U. 90-17/18/55, at 139 (1990).

2. Bay State Gas Company shared the cost of O'Laughlin's testimony with Colonial

(Tr. 3, at 179).

3. Impact evaluations use quantitative analyses to assess energy and capacity savings resulting from the implementation of DSM programs. MECo at 1.

4. GEMS was a comprehensive research project which used a variety of analytical tools to evaluate the effectiveness of residential and multi-family natural gas DSM programs. D.P.U. 94-15, at 1 n.1.

5. GEMS method refers to the overall analytical framework established by Boston Gas Company to (1) determine the effectiveness of Boston Gas Company's residential DSM programs by estimating the amount of gross energy saved from a sample of its residential customers, (2) transfer these results to its residential DSM and non-host local distribution companies' DSM programs, and (3) adjust gross savings to account for factors that affect net program savings. D.P.U. 94-15, at 1 n.2.

6. The Department notes that the Company's Peak 1997/98 cost of gas adjustment factor, approved on October 31, 1998, includes the LBR and carrying costs proposed for recovery in this proceeding.

7. [7] A DSM tracking system contains estimates of the savings based on the original engineering estimate of savings for each measure. Bay State Gas Company,

D.P.U. 96-98, at 4 (1997). An impact evaluation, on the other hand, estimates the amount of savings actually achieved. Id. The ratio of this latter estimate to the former tracking estimate is called a "realization rate." Id.

8. Once a utility completes a rate case, that utility's LBR is reduced to zero. As time between rate cases increases, the LBR portion of a utility's total DSM budget increases.

9. [9] Colonial's last four base rate cases were filed in: (1) April 1993; (2) April 1990;

(3) April 1984; (4) May 1982 (Exh. AG-2-18).

10. [10] The Company took into consideration only domestic hot water DSM measures for one of the three electric companies and only residential DSM programs for one of the five LDCs (id.).

11. [11] The Company's gross LBR estimates are defined as the base year gross non-fuel margins for both industries. They are the non-fuel transmission and distribution revenue per KWH for electric utilities and the non-gas distribution revenue per Dth for gas utilities (Exh. C-22). Colonial subtracted avoided costs from gross LBR to arrive at net LBR estimates.

12. [12] The Company indicated that the operating cost savings values have two components: a T&D capital recovery value and a non-fuel operation and maintenance value

(Exh. C-16, at 22). For the T&D capital recovery value, the Company used representative figures for both industries based on a composite of avoided cost studies previously approved by the Department (Exh. C-16, at 22). The Company noted that it relied on Colonial Gas Company, D.P.U. 96-18 (1996) and Boston Gas Company D.P.U. 94-109 (1996) for gas companies and Boston Edison Company, D.P.U. 95-1-CC (1995) for electric companies (Exh. C-16, at 22). The Company also analyzed the long-term change in non-fuel O&M expenses per increment in firm throughput for both industries (Exh. C-16, at 22-23). Colonial computed the change in non-fuel operating costs as a proportion of the change in firm throughput for 1987-1996 (Exh. C-16,

at 23).

13. [13] In calculating the total avoided cost for gas utilities, the Company had two base year avoided non-fuel O&M cost figures, $0.958/Dth for the period 1992-1998 and $0.761/Dth for the period 1987-1992. (Exh. C-24, at 1). The Company used the lower-cost, 1987-1992 figure in determining net LBR streams.

14. [14] The Company's calculation yielding the six year recovery period for gas utilities shows that the total discounted gas net LBR stream for 16 years equals $12.92 per dekatherm (Exh. C-20, at 2). Since values for discounted gross LBR stream for the first six years are $2.829, $2.572, $2.338, $2.125, $1.932 and $1.757 per dekatherm, respectively, by the end of sixth year the total equals $13.55 per dekatherm, which indicates 6 years of recovery.

15. [15] The Company witness stated that, to his knowledge, this was the first study done on this subject (Tr. 3, at 210). The witness also stated that he was not aware of any other states that have implemented a six to ten-year rolling period for gas company LBR recovery, or other studies that propose a six to ten-year rolling-period recovery for LBR (id. at 211).

16. [16] The LDCs state that they reserve the right to seek LBR for market transformation programs if necessary in the future and that they have been able to forgo recovery of LBR for market transformation programs because of the LBR recovery policy on the traditional, rebate-based programs (LDCs' Brief at 12).

17. [17] Under Berkshire Gas Company, D.P.U. 96-92 (1996), Commonwealth Gas Company, D.P.U. 95-114 (1996) and Fall River Gas Company, D.P.U. 97-62 (1997), each of the companies collects some incentives.

18. [18] We also note that each of Colonial's LBR recovery filings was separately docketed and a decision was issued after notice and hearing. See Colonial Gas Company,

D.P.U. 96-91 (1996); Colonial Gas Company, D.P.U. 96-95 (1997).

19. We also note that for the period May 1997 to April 1998, Colonial has requested LBR and carrying cost recovery of $1,238,695. Colonial Gas Company, D.T.E. 98-95 (September 17, 1998 Company letter to the Department).

20. [20] The Department also approved LBR recovery of $112,121 for all C&I DSM measures installed from inception through April 1995. Colonial Gas Company, D.T.E. 96-31 (1997). Further, in compliance with Boston Gas Company, D.P.U. 94-15 (1995), the Department approved $696,667 LBR recovery for Colonial's residential DSM programs from October 1992 to April, 1995 (Exh. C-13, at 6-8).

21. [21] We note that the Company presented no evidence that its proposed method for LBR recovery has been proposed or adopted in other jurisdictions.

22. See footnote 11 above for an explanation of gross and net LBR.

23. [23] We note that the Department, contrary to the Company's assertion, did not approve a standard three-year rolling period for each electric company. Instead, the Department approved a company-specific rolling period based almost exclusively on the average

historic time span between the last four rate cases for each company. See Boston Edison Company, D.P.U. 95-1-CC at 65 (1994).

24. [24] At the time of the hearings in this proceeding, there were ten investor-owned gas LDCs and seven investor-owned electric distribution companies in Massachusetts.

25. The record indicates that the Company's witness on LBR incorrectly assumed that the Rolling Period Method for electric companies was fixed at three years

(see Exh. C-16, at 3).