STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of National Fuel Gas Distribution Corporation for Gas Service.	Case 07-G-0141

NEW YORK STATE CONSUMER PROTECTION BOARD'S

BRIEF ON EXCEPTIONS

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Albany, New York

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I. Statement of the Case

This case was initiated by a filing dated January 29, 2007, in which National Fuel Gas Distribution Corporation ("NFG or Company") requested a $51.98 increase in its rates and charges for natural gas delivery service. The request included funding for a new Conservation Incentive Program aimed at promoting the efficient use of natural gas by NFG's customers, and proposed a Revenue Decoupling Mechanism ("RDM") to hold the Company harmless to conservation-induced reductions in gas usage. NFG's filing also called for a substantial curtailment of its retail access promotion activities, and proposed numerous other taiff changes.

On June 7, 2007, the New York State Consumer Protection Board ("CPB"), Department of Public Service Staff ("DPS Staff"), Direct Energy Services, LLC ("Direct Energy") and the Independent Oil & Gas Association of New York ("IOGA") submitted testimony. NFG filed rebuttal testimony on June 28, 2007. Evidentiary hearings were held on July 23 and 24, 2007, before Administrative Law Judge William Bouteiller

(“ALJ”). Following the hearings, the CPB, DPS Staff, Direct Energy, Multiple Intervenors (“MI”), the New York State Energy Research and Development Authority (“NYSERDA”) and the Company filed initial and reply briefs. In addition, on the date set for reply briefs, IOGA and Constellation New Energy-Gas Division, LLC (“CNE”) filed comments to which NFG subsequently responded.

On September 28, 2007, the Recommended Decision of the ALJ (“RD“) was issued for exceptions by the Secretary to the Commission pursuant to 16 NYCRR § 4.10.[1] The RD concludes that NFG’s delivery rates should be increased by $2.514 million, and resolves a wide range of other issues raised by the parties.

II. Summary of Basic Position

The RD presents a thorough, thoughtful and fair analysis of the contested issues and evidence in this case. In general, its conclusions are clearly within the range of outcomes that would be considered fair to both the Company and consumers. Our exceptions are directed at a limited number of issues on which we believe the RD is mistaken or unclear.

Specifically, we address the following matters:

- **Return on Equity (ROE)**. The RD erred in applying a 50/50 weighting to the results of the Discounted Cash Flow (“DCF”) and Capital Asset Pricing (“CAPM”) models in calculating ROE, rather than the two-thirds, one-third weighting prescribed by the recommended decision in the Generic Finance Proceeding

[1] The Recommended Decision will be cited herein as “RD” followed by the page number, e.g. “RD 10.”

("Generic Finance").[2] The record does not present any information concerning the DCF model not inherently subsumed in the Generic Finance methodology, and did not allege any unique circumstances justifying a deviation from that methodology.

- **Conservation Incentive Program (CIP)**. Having found that a determination of the responsibility of various service classes for the funding of a CIP on NFG should await findings from the pending Energy Efficiency Portfolio Standard proceeding[3], which could be considered by the parties in the collaborative ordered by the Commission,[4] the RD nevertheless concluded that large customers should not contribute to the program for the rate year. We recommend that the Commission await the results of the collaborative before deciding this issue.
- **Revenue Sharing Mechanism for Off-System Sales and Capacity Release**. Uncontradicted testimony from DPS Staff, the Company and the CPB demonstrated that the optimization of gas supply costs through off-system sales and capacity release is a fundamental obligation of gas utilities. In no other area of utility operations does the Commission ask ratepayers to pay incentives for the achievement of the minimum level of performance expected. The RD erred in allowing the Company to retain 15% of off-system sales and capacity release

[2] Case 91-M-0509, Proceeding on Motion of the Commission to Consider Financial Regulatory Policies for New York State Utilities.

[3] Case 07-M-0548, Proceeding On Motion of the Commission Regarding an Energy Efficiency Portfolio Standard, "Order Instituting Proceeding," issued May 16, 2007, ("EPS Proceeding").

[4] "Order Adopting Conservation Incentive Program," issued September 20, 2007, ("September 20 Order"), p. 12.

revenues from the first dollar earned, depriving ratepayers of at least $150,000 in gas cost credits annually.

- **No Harm, No Foul Rule**. The RD correctly recognized the problems presented by this rule, but the compromise solution it recommended is unnecessarily complicated. The rule should have been eliminated.
- **Retail Access**. The elimination of the Market Match and Market Expo programs, in their current forms, was unopposed. The reduction in outreach and education ("O&E") spending for retail access proposed by the Company was supported by DPS Staff and CPB. The RD should be clarified to state that the revenue requirement determined by the ALJ does not include funding for Market Match and Market Expo, and includes funding for O&E only at the levels proposed by NFG.
- **Comments of CNE**. The comments of CNE submitted late in this proceeding amount to nothing more than a request for continued ratepayer subsidization of ESCO profits, with no evidence that such subsidies are necessary to promote retail competition. They should be firmly rejected by the Commission.

III. Exceptions

A. Return on Equity

In calculating a recommended ROE for the Company, the ALJ gave equal weight to the results of the DCF and CAPM models rather than the two-thirds, one-third ratio adopted in the Generic Finance case, which has been applied consistently for the last

13 years. This increased the RD's recommendation by thirty basis points, from 9.1% to 9.4% (each rounded).[5]

The ALJ justified the deviation from the Generic Finance methodology on the grounds that the DPS Staff did not fully address NFG's assertion that the DCF methodology produces unreliable results when market prices vary from book values. (RD 9) "Absent a defense of the continued application of the DCF in the currently prevailing market decisions," he concluded, the weight accorded the DCF methodology should be reduced. (RD 10)

This holding was in error. The Company presented nothing new or unusual that would justify compelling DPS Staff, or any party, to defend the well-established and consistently applied Generic Finance methodology.

Company witness Hanley testified that it is a characteristic of the DCF model that the cost rates it generates will produce returns on book equity equal to the returns expected by investors only when market and book values are equal, and that "[m]arket values and book values of common stocks are seldom at unity." (Tr. 163) To conclude that this information justifies a change in the Generic Finance methodology, we would have to assume that the many experts who participated in the Generic Finance case were unaware of the fundamental workings of the DCF model. This is implausible. Clearly, the effect of the market to book ratio on the DCF model would have been well-known by the participants in developing their recommendation that ROE be calculated using a weighted, multi-model methodology.

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5 Calculated by applying a two-thirds, one-third weighting to the model results presented at RD Appendix 2, page 3 of 6.

Furthermore, Mr. Hanley's testimony demonstrates that the market conditions currently faced by NFG are not new. He says that the average market values of the proxy groups of LDCs exceeded their book values throughout the five-year period ending in 2005. (Id.) During that period, the Commission repeatedly reaffirmed the viability of the Generic Finance methodology.[6] The fact that market values continue to exceed book values does not constitute special circumstances justifying a deviation from the methodology in this case.

The Commission customarily recalculates ROE using data available at the time it issues its decision. The CPB recommends that the weighting accorded to the DCF and the CAPM model results in that recalculation stand as prescribed in the Generic Finance case.

B. CIP Funding

On the issue of whether large customers not directly eligible for participation in CIP programs should, nevertheless, be required to contribute to their funding, the RD concluded that the record in this case was not sufficient to permit a reasoned consideration of all opposing viewpoints. (RD 58) It said the issue should be developed more fully in the context of the statewide EPS proceeding, and in the forthcoming NFG-specific collaborative.[7] Having made a good case for the proposition that a decision on funding issues was premature, the RD nevertheless recommended that large customers not be required to pay CIP costs for the rate year. (Id.)

[6] See e.g. Case 05-E-1222, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Electric Service, "Order Adopting Recommended Decision with Modifications," Issued August 23, 2006, at p. 95.

[7] September 20 Order, p. 12.

This conclusion was unnecessary. As the Commission stated in its September 20 Order, "sufficient results should be available from the generic [EPS] proceeding to inform the parties who will also participate in [the] collaborative process" that will be convened to develop a more detailed CIP proposal for the 2008-2009 program year.[8] In the meantime, NFG will be fully protected financially by the Commission's authorization in its September 20 Order for the deferral of all costs and lost revenues associated with the 2007-2008 program.[9] Accordingly, the Commission should direct that the issue of the contribution of the various NFG service classes to the funding of the CIP be included among those to be considered by the collaborative in contemplation of a final PSC decision prior to the 2008-2009 winter heating season.

C. Off-System Sales and Capacity Release Revenue Sharing

Under NFG's existing revenue-sharing mechanism, the first $1 million in net revenues earned by the Company from off-system sales and capacity release transactions is credited to a Cost Mitigation Reserve ("CMR") which is used to offset expenses that would otherwise be borne by ratepayers. Above $1 million, NFG is permitted to retain 15% of net revenues as an incentive to increase the income it generates through the optimization of gas supply assets. Firm sales customers receive the remaining 85% as a credit to the GAC. Thus, if the Company achieves its recent annual average of approximately $5 million in off-system sales and capacity release

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[8] Id.

[9] September 20 Order, ordering clause 3, p. 14.

revenues, ratepayers receive a total benefit of $4.4 million, and NFG earns a $0.6 million incentive.[10]

The CPB proposed that both components of the sharing mechanism be changed. First, we said that the threshold that must be met before the Company is entitled to a share of the revenues should be raised from the current $1 million to $2 million.[11] Second, we recommended that NFG's share of revenues above the threshold be raised from 15% to 20%. Under this proposal, if the Company brought in its average of $5 million in net revenues, ratepayer and Company shares would be the same as they are under the current mechanism, $4.4 million and $0.6 million. In rebuttal testimony, the Company stated its willingness to accept the CPB's recommendation. (RD 93)

Despite this, the RD recommended that all off-system sales and capacity release revenues be shared on an 85%/15% basis, with no threshold. (Id.) Under this formula, $5 million in net revenues would produce only $4.25 million for ratepayers, with $0.75 million going to NFG, a loss of $150,000 annually for sales customers.

Our recommendation that the sharing threshold be increased was based upon the realization that off-system sales and capacity release activities by utilities are no longer the experimental undertakings they were when the Commission adopted its "placeholder" 85/15 sharing formula in 1994.[12] This type of management of the gas supply assets that have been paid for by ratepayers has become the norm. On this

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10 The average for the years 2001 through 2006 was $5.3 million. "Initial Brief of the New York State Consumer Protection Board," filed August 15, 2007, ("CPB Initial Brief"), p.11.

11 As the RD correctly notes at page 93, we originally proposed that the threshold be raised by increasing NFG's contribution to the CMR. In response to concerns about the continuation of that reserve, we amended our proposal on brief to state that if the CMR were discontinued, the first $2 million in off-system sales and capacity release revenues should be flowed back to ratepayers through the GAC.

12 CPB Initial Brief, p. 12, and Tr. 599-600.

point, there was no dispute in this case. The Company, DPS Staff and the CPB all agreed that the use of off-system sales and capacity release transactions as a means of managing gas supply costs should be considered a fundamental obligation of gas utilities.[13]

In no other area of utility responsibility does the Commission provide an incentive for doing the absolute minimum expected. Incentive mechanisms related to safety, customer service, and retail competition, for example, all have minimum threshold requirements, usually calling for an improvement on, or at least maintenance of, previously achieved performance levels.[14] By contrast, despite the parties' agreement that off-system sales and capacity release are activities in which NFG must be engaged in order to do its job properly, the RD would pay the Company an incentive from the first dollar earned.

Even if the Commission disagrees with the CPB's proposal, some minimum threshold for revenue sharing should be retained. At the very least, the existing $1 million threshold under which NFG has been operating in current rate plan should be continued.

On the issue of the sharing formula, the RD concludes that there is "no known advantage for ratepayers" in choosing between 85%/15% sharing with no threshold, and 80%/20% with a $2 million threshold as proposed by the CPB. (RD 94) This is simply not correct. As we showed above, the CPB proposal would produce $150,000

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[13] See Tr. 599 for the CPB; Tr. 843 for the Company and Tr. 515 for the DPS Staff.

[14] See e.g., Case 04-E-0573, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Consolidated Edison Company of New York, Inc. for Electric Service, "Order Adopting Three-Year Electric Rate Plan," issued March 24, 2005, approving an ESCO migration incentive requiring a minimum of 25,000 customers to switch to ESCO service before any incentive is paid. (Joint Proposal, p. 30, attached to the Commission Order.)

more in benefits for ratepayers than the RD's formula if NFG achieved its historic average of $5 million in revenues. In fact, as we underscored in our Reply Brief, for the formula chosen by the ALJ to provide as great a benefit to ratepayers as the one proposed by the CPB, NFG would have to bring in $8 million in revenues, a nearly 60% improvement over their previous average performance.[15]

The RD generates a loss for ratepayers compared to a proposal that the Company has already indicated it is willing to accept, and against which no cogent argument has been made. The RD's recommendation for off-system sales and capacity release revenue sharing should be rejected, and the CPB's proposal that ratepayers receive the first $2 million in revenues and 80% thereafter should be adopted.

D. No Harm, No Foul Rule

The ALJ agreed with the position of the CPB and the Company that the so-called "no harm, no foul" rule inequitably permits smaller marketers to get a free ride from larger marketers whose daily balancing efforts tend to keep the entire SC13D pool within tolerances. (RD 74) Rather than eliminate the rule, as we and NFG urged, however, he adopted a compromise position, directing the Company to establish separate balancing pools for small and large marketers. (Id.)

This is an innovative solution that the CPB had not considered, and we agree that it should remove the inequity at which it is directed. It is clearly better than the existing rule. Nevertheless, we are concerned that it creates a more complicated process that may present monitoring problems for NFG, and we continue to maintain

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15 "Reply Brief of the New York State Consumer Protection Board," filed August 27, 2007, p. 4.

that the record in this case strongly supports the much simpler solution of eliminating the rule entirely.

Supporters of the status quo presented two basic arguments for retention of the rule. First, MI suggested that it would be unfair for any marketer to be cashed out at punitive price levels when NFG's system, as a whole, was in balance and unharmed.[16] The argument ignores the fundamental purpose of "punitive" cash-out levels, which is not to compensate NFG for damage actually incurred, but rather to influence the behavior of individual marketers so as to minimize the likelihood that such damage will ever occur.

In this regard, cashouts play a role very similar to the "negative incentives" commonly used by the Commission to enforce standards of safety and customer service for utilities. Imagine what the reaction of the PSC would be if some gas company objected to being sanctioned for failing to meet a leak repair target on the grounds that it had not experienced any explosions during the year! The same reaction should greet marketers who contend that their excessive imbalances should not be cashed out because, fortunately, the actions of others kept the system in balance.

The second argument for retention of the rule is the DPS Staff's contention that it serves to compensate for the unavailability of imbalance trading at the daily balancing level. (Tr. 500) As we demonstrated in our initial brief, this is simply not the case. It is the 10% tolerance band that compensates for the absence of trading. At the monthly balancing level, where trading is available, there is no tolerance band. All imbalances are cashed out. At the daily level, where there is no trading, imbalances from 10% short to 10% long incur no cashout. This degree of flexibility is more than adequate. The "no

[16] "Initial Brief of Multiple Intervenors," filed August 15, 2007, pp. 71-72.

harm, no foul" rule is completely superfluous in addition to being inequitable. It should be eliminated.

E. Retail Access

In its order initiating a review of retail access policies, the Commission encouraged parties to address existing programs in the context of rate proceedings, despite the pendency of the generic case, because doing so would help it respond more rapidly to identified issues.[17] The parties have done that in this case, and most of the issues were resolved by the ALJ. On two matters, however, the RD requires clarification.

The first concerns the Market Match and Market Expo programs. NFG proposed that they be eliminated. The CPB supported the Company's proposal, and no party disagreed with the contention that the programs have outlived their usefulness as currently designed. Direct Energy, however, proposed that rather than being scrapped, they should be re-targeted from the largest gas users, who no longer need them, towards smaller customers.

The RD concluded that consideration of Direct Energy's proposal should await the results of the generic retail access proceeding. (RD 79) It did not, however, say what should be done with the existing programs in the interim. Given the absence of any support for continuation of the current Market Match and Market Expo programs, the CPB recommends that the Commission terminate them now. Whether similar programs might be useful for smaller customers, as Direct Energy suggests, is a topic

[17] Case 07-M-0458, Proceeding on Motion of the Commission to Review Policies and Practices Intended to Foster the Development of Competitive Retail Energy Markets, "Order on Review of Retail Access Policies and Notice Soliciting Comments," issued April 24, 2007, pp. 7-8 ("Retail Access Order").

better left for consideration in the generic proceeding where a wider range of options will be presented.

The second retail access issue involves Company spending for customer outreach and education activities. NFG proposed to curtail its efforts significantly. (RD 78) The CPB recommended that the Company proposals be strengthened further. (Tr. 611) Direct Energy favored eliminating entirely O&E aimed at creating customer awareness of competition and alternative suppliers. (RD 78) With this essentially unanimous support for a substantial reduction in O&E expenditures, the RD should not have left the decision to the generic proceeding. (RD 79) At a minimum, the Commission should order the reductions proposed by NFG.

Under any circumstances, the Commission needs to clarify whether, and to what extent, continued funding for Market Match, Market Expo and retail access O&E has been included in the revenue requirement authorized for NFG. The RD's calculation of revenue requirement begins with the data presented in Attachment A to the DPS Staff's Reply Brief.[18] The line items in that attachment give no indication whether funds are earmarked for these retail access programs, so it is not clear whether any such amounts have been carried forward in the RD's calculations. This should be clarified and, if our recommendations above are accepted, any funds allocated to the programs that are included in the proposed revenue requirement should be removed.

F. Comments of CNE

In comments filed on the due date for reply briefs, CNE objected to the CPB's proposal that NFG be permitted to retain 20% of net income from off-system sales and

[18] "Reply Brief of the Department of Public Service Staff," filed August 27, 2007.

capacity release above the first $2 million.[19] Because these comments consisted of unsubstantiated assertions never before raised by any party, they were not only improper for a reply brief, but in effect, they constituted direct testimony filed three months too late.

NFG correctly moved to dismiss CNE's filing, but the ALJ denied the request, reasoning that the comments were very brief, that NFG had replied to them in its motion, and that other parties could address them in their briefs on exceptions. The Commission should reverse this decision and strike the comments from the record.

The insertion of new issues at a point in a fully-litigated proceeding where discovery and cross-examination by opponents are no longer possible is inherently unfair. Furthermore, the comments contribute nothing to a complete record because, being largely untested, they are entitled to virtually no weight. As a procedural matter, the Commission should take this opportunity to make it clear that it will not condone this type of “sandbagging.”

Substantively, the comments deserve even less consideration. Their basic argument is that if the Commission increases NFG's incentive to generate off-system sale and capacity release revenues, the Company may do more sales and release less capacity to marketers. The implication is that off-system sales tend to be more profitable than capacity release and CNE does not want NFG keeping the higher valued deals for itself.

What CNE’s complaint ignores is that 80% to 85% of the revenue generated by NFG's off-system sales and capacity release activities will go directly to ratepayers. NFG's customers pay 100% of the cost of the capacity supporting these transactions

[19] The CPB proposed that 100% of the first $2 million be credited to ratepayers.

and they are entitled to expect the Company to maximize their return on that investment. By asking the Commission to minimize NFG's incentive to pursue the highest valued transactions so that CNE will have a better chance of securing them for itself, CNE is effectively lobbying for indirect ratepayer subsidization of its profits. This is directly contrary to the course charted by the PSC in its Retail Access Order.[20] If not dismissed, CNE's comments should be rejected.

CONCLUSION

With the few modifications and clarifications we recommend herein, the Recommended Decision of the ALJ in this proceeding should be adopted by the Commission.

Respectfully submitted,

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Chairperson and Executive Director

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David Prestemon
Intervenor Attorney

Dated: Albany, New York
October 18, 2007

[20] See discussion at p. 6 of the Order.