Public Service Commission
State of New York

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of National Fuel Gas Distribution Corporation for Gas Service.	:	Case 13-G-0136

Department Of Public Service Staff Brief On Temporary Rates

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STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

Case 13-G-0136 - Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of National Fuel Gas Distribution Corporation for Gas Service.

DEPARTMENT OF PUBLIC SERVICE STAFF BRIEF ON TEMPOARY RATES

I. INTRODUCTION

This Brief is submitted by Department of Public Service Staff (Staff) in accordance with the scheduling notice filed on May 6, 2013. This brief addresses the limited issue of setting temporary rates for National Fuel Gas Distribution Corporation (National Fuel or Company), and more specifically freezing National Fuel's current gas rates subject to refund and allow for a more detailed and extensive investigation of National Fuel's future permanent rates.[1] After limited discovery and time constrained review of National Fuel's submissions, Staff recommends that National Fuel's current gas rates be made temporary by freezing current gas rates subject to refund. Staff bases its recommendation on its analysis and findings that National Fuel's estimated return on equity (ROE) for the twelve months ending May 31, 2014 will conservatively be 11.06%, and that the Commission's current allowed ROE is approximately 9.0%. This approximate 200 basis point difference equates to $10.3 million in rates that Staff believes to be unreasonable and not necessary for the provision of safe and adequate service.

[1] This brief will not directly address the Company's proposal filed in March 2013 or any issues related to Public Service Law (PSL) §66(20). These areas are not relevant to the issue of freezing current rates subject to refund.

Therefore, it would be in the public interest, in accordance with PSL §114, to review National Fuel's permanent rates by freezing current rates subject to refund at this time.

Staff believes that the above ROE differential, along with the continuation of increasing deferrals owed by ratepayers,[2] is adequate for the limited purpose at this stage of this proceeding to freeze rates subject to refund. In essence, Staff recommends this action "start the clock running" and allow for a more thorough and accurate estimation of National Fuel's future permanent rates.[3] The Company has not established that it would be harmed by this recommendation,[4] and therefore, Staff believes that this suggested process is fair and reasonable to both National Fuel and National Fuel's ratepayers.

On April 19, 2013, the State of New York Public Service Commission (Commission) issued an Order Instituting

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[2] The deferral balance as of September 30, 2012 is approximately $24.3 million, to be recovered from ratepayers. An additional$9.2 million is expected to be accrued within the fiscal year ended September 30, 2013. The major drivers of the additional deferrals are for pension expense and carrying charges related to pension funding (see Sec. V for a complete discussion).

[3] Case 06-E-1433, Orange & Rockland - Rates, Order Making Temporary Rates Subject To Refund (issued March 1, 2007)(O&R Order), p. 6.

[4] O&R Order at pp. 11-14 - Orange & Rockland (O&R) claimed the possibility of financial credit downgrades as potential harm. The Commission (at 13-14) recognized this possibility, determined that this possible negative effect would not be great and was outweighed by the benefit of resetting permanent rates. National Fuel's credit rating has not been downgraded since the initiation of this proceeding and the stock price of National Fuel Gas Company (NFG), the parent holding company, has remained relatively constant. Therefore, it appears that the financial markets have identified little negative effect caused by the temporary rate process or by freezing current rates subject to refund as recommended by Staff.

Proceeding and To Show Cause[5] to start this proceeding to review the gas rates of National Fuel, and mandated that the Company show cause as to why current gas rates should not be made temporary subject to refund. The OTSC explained that the Commission last established rates for National Fuel in Case 07-G-0141,[6] that these rates have been in effect since January 2008, and that under the one-year litigated 2007 Rate Order, "…there is no ROE earnings sharing mechanism, and, therefore, National Fuel retains all excess earnings when they occur."[7] The Commission further reviewed the Company's March proposal that offered the implementation of an earning sharing mechanism (ESM) at an ROE of 9.96% and the acceleration of its infrastructure modernization program to share the recognized over earnings with ratepayers. While commending National Fuel on its cost-saving measures resulting in greater profit, the Commission noted that "National Fuel's Proposal recognizes that its various costs saving and control measures have reduced the cost of operating the Company's business in New York to a level below what it was when rates were last set…in 2007."[8]

Most importantly for the purpose of this temporary rate exercise, the Commission stated that "…a process will be developed to examine the resetting of the Company's rates going forward…. The Company's Proposal makes no provision to fully protect ratepayers' interests while this case is moving forward

[5] Case 13-G-0136, National Fuel - Rates, Order Instituting Proceeding And To Show Cause (issued April 19, 2013)(OTSC).

[6] Case 07-G-0141, National Fuel - Rates, Order Establishing Rates For Gas Service (issued December 21, 2007)(2007 Rate Order).

[7] OTSC at 1.

[8] OTSC at 4.

to that conclusion."[9] Staff's recommendation provides this ratepayer protection while maintaining the status quo and holding the Company harmless.

The only issue calling for a Commission determination at this time is whether the difference between the approximate currently allowed ROE of 9.0% and Staff's conservative forecasted ROE of 11.06%, while deferrals continue to increase, is sufficient to set temporary rates by freezing current rates subject to refund and provide for the permanent rate process to go forward. This question inherently provides its own reasonable answer that is recognized by all parties, even National Fuel, that the Company's rates may well be unnecessarily high to support current operations. This ultimate conclusion calls for the acceptance of Staff's recommendation.

II. PARTY SUBMISSIONS

National Fuel OTSC Response[10]

In compliance with the OTSC, National Fuel submitted witness testimony and exhibits[11] on May 8, 2013, generally opposing the setting of temporary rates and expressing the Company's opinion that its efforts to cut costs while providing

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[9] OTSC at 5.

[10] National Fuel's response contained many discussions and reached conclusions that have no relevance to the ROE differential issue to be decided here. Statements concerning the level of service, the level of National Fuel's rates compared to other utilities and the level of allowed returns of other utilities are not relevant to and should have no bearing on the ultimate issue of setting temporary rates for National Fuel to fully protect ratepayers while the process for setting permanent rates goes forward.

[11] National Fuel submitted the testimony of Eric Mienl (May 23, 2013 Hearing Transcript (Tr. 7-50) and Regina Truitt (Tr. 66-97) with corresponding exhibits (Hearing Exhibits 2 and 3, respectively).

safe and reliable service was being penalized and that they were treated unfairly by the issuance of the OTSC. Although not ultimately relevant, the Company questioned Staff's estimated adjusted ROE of 13.15% for the twelve months ending September 30, 2012. Also, National Fuel questioned Staff's conclusion, as of the date of the OTSC, that "…National Fuel will be earning, with rates set in the 2007 Rate Order, at or near the 2012 levels for fiscal year 2013, and deferral levels are expected to likewise continue in 2013."[12] The Company disagreed with this conclusion and provided data forecasting that the ROE for the twelve months ending May 31, 2014 would be nowhere near the exorbitant 2012 level,[13] but instead drastically drop to a level near what is currently allowed, that future estimated level being 9.22%. Tr.11 Not surprisingly, the Company believes that if this newly forecasted ROE is accepted, the setting of temporary rates is not necessary.

For the most part, the Company justified such a drastic reduction in ROE by: i) questioning the continuance of the New York State Office of Real Property Tax Services (ORPTS) obsolescence determinations reducing property taxes (Tr.83-86), ii) providing a new methodology to calculate the earnings base capitalization (EB/Cap) adjustment using a two year average (Tr.89-96), iii) using a common equity ratio in the capital structure of 55% (Tr.32-34, Hearing Exhibit 3 (RLT-1, Schedule 1, Sheet 1).

Staff Testimony and Exhibits

After reviewing the Company's responsive position and information, on May 20, 2013, Staff filed the testimony of the

[12] OTSC at 3.

[13] National Fuel reported that the 2012 ROE was 12.41%.

Temporary Rates Panel (Panel) and exhibits (TRP 1-13).[14] Staff's review led to several adjustments to the Company's newly projected ROE of 9.22% resulting in a conservative ROE estimate for the twelve months ending May 31, 2014 to be 11.06%. Tr.123-124 As explained in greater detail below, the Panel did not accept: i) the Company's premise that its property taxes would go against the historical trend and would now increase - Staff reasonably recommended that property taxes be held constant at the current level (17 basis point ROE increase)(Tr.159-164); ii) that the EB/ Cap should now be averaged over a two year period leading to a lower ROE than had the Company followed the long established methodology to use the historical EB/Cap unadjusted (44 basis point ROE increase)(Tr.153-158); and iii) that the 55% common equity ratio in the capital structure should be used, but instead equitably recommended following recent Commission determinations and accepted practice to calculate and use a 48% ratio (80 basis point increase) (Tr.152-153). Additionally, the Panel recommended that the imputation of the Commission's traditional 1% productivity adjustment be made resulting in a 15 basis point ROE increase (Tr.164-165), and recommended adjusting the Net Plant forecast resulting in a 19 basis point increase (Tr.165-168). Finally, the Panel made an adjustment of 9 basis points to reflect the continued amortization of the tax benefit of the Medicare subsidy received by National Fuel (Tr.168-172).

Further, the Panel pointed out that an increase of labor expense by 8% was not in line with historical labor expense and that a sharp increase in health care expense should likewise be more thoroughly investigated in the permanent rate

[14] Staff Panel testimony, Tr.113-213, and Hearing Exhibits 4-16.

proceeding (Tr.172-183).[15] However, under the limited time frame for discovery and review, Staff did not make a quantifiable adjustment, but recommended that these areas be investigated in more detail during the permanent rate process. Tr.175-176; 180; 182-183).

<u>National Fuel Rebuttal</u>

On May 22, 2013, National Fuel filed rebuttal testimony prior to the May 23, 2013 evidentiary hearing. Much of National Fuel's rebuttal is not relevant to the limited issue of determining appropriate ROE endpoints. National Fuel attempts to rebut and joins issue on only two of Staff's ROE adjustments, property taxes and EB/Cap.[16] Tr.98-102[17]

The Company points out that the actual 2013 Town and County property taxes show a 1.77% increase from 2012 (Tr.100-101), which it believes would lower the Panel's forecast ROE.

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[15] While the Administrative Law Judges (ALJs) stated that they would give little weight to these conclusions when presumably making a recommendation to the Commission (Tr.111-112), Staff points out that the Staff in the O&R temporary rate proceeding also made a conservative estimation of O&R's future ROE. The Commission (O&R Order at 9) accepted that ROE estimation as conservative when freezing rates subject to refund. The purpose of the Panel testimony on these adjustments was to demonstrate the importance of "starting the clock" for further permanent rate review.

[16] The potential total value of these two adjustments is 61 basis points. Therefore, it appears the Company concedes that the projected ROE for the twelve months ending May 31, 2014 is no lower than 10.45%.

[17] Further, because the Company used a 55% common equity ratio (Tr.32-34), Staff presumes that National Fuel would not agree to using a 48% ratio as recommended by the Panel, even though it did use the 48%, 50% and 55% ratios in Hearing Exhibit 3 (RLT-1, Schedule 2, Sheets 1-4) to calculate its earned return for the year ended September 2012. Therefore, because there will be no reply briefs, this issue will also be addressed below in Sec. IV.A.

Concerning the EB/Cap, the Company believes the use of a two year average to compute the EB/Cap adjustment is more appropriate than using the historic test year ending September 30, 2012 amount, due to volatility. Tr.98

Summary

As the Commission has recognized, "…making rates temporary now does not represent a definitive determination that the Company is over-earning or a quantification of the level of over-earning, it affords us the ability to collect such over-earnings for the benefit of ratepayers upon such a finding made at a later time upon a more complete record."[18] Therefore, "…where there is a reasonable basis to believe that ratepayers are currently being harmed by the level and structure of rates, the institution of temporary rates is an important tool for ratepayer protection that should be used now to further the public interest."[19] These statements are the essence of Staff's recommendation to freeze current rates subject to refund. After reviewing and analyzing the Company's initial OTSC response and rebuttal testimony, Staff continues to opine that there is a reasonable basis to make rates temporary by freezing rates subject to refund because the Company's estimated ROE for the twelve months ending May 31, 2014 is in excess of 11%, while ratepayer owed deferrals are increasing. This alone allows the Commission "to start the clock" from the date of issuance of the temporary rate order to fully protect ratepayers and allow any further later determined overearnings to be shared for ratepayer benefit.

[18] O&R Order at 6-7.

[19] O&R Order at 7.

Further, while exactitude of adjustments is not called for in a temporary rates proceeding, the Company has not rebutted the Panel's use of a 48% common equity ratio, or additional productivity, net plant forecast and Medicare subsidy income tax adjustments. Finally, while the Company continues to argue against Staff's property tax and EB/Cap adjustments, such attack is of little avail[20] and Staff's ROE should be accepted as a reasonable estimation and a basis to freeze current rates subject to refund.

III. <u>RETURN ON EQUITY</u>

A. <u>The Panel's Derivation of the 9.0% Allowed ROE As A Floor to Determine National Fuel's Earnings is Reasonable</u>

The Commission made its most recent ROE authorization for a major utility company in March 2013 in Cases 12-E-1201 and 12-G-1202. The Commission allowed a 9.3% ROE for Niagara Mohawk.[21] As explained below, the Panel developed a reasonable estimate of 9.0% to employ in this proceeding by adjusting the Niagara Mohawk 9.3% ROE. Tr. 200-201

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[20] As explained below, at most the 1.77% increase in actual 2013 Town and County property taxes should be offset by the increase in the ORPTS obsolescence determination, resulting in virtually no overall property tax increase. However, even without an offset, this increase would result in only a 3 basis point reduction to the Panel's 11.06% estimated ROE (Town/County Tax of $8,996,000 x 1.77% = $159,000 and 1 basis point is approximately worth $50,000).

[21] Cases 12-E-0201 and 12-G-0202, <u>Niagara Mohawk Power Corporation d/b/a National Grid - Electric and Gas Rates</u>, Order Approving Electric and Gas Rate Plans in Accord with Joint Proposal (issued March 15, 2013) (Niagara Mohawk Order), pp. 38-42.

First, Staff in the Niagara Mohawk proceeding recommended a one-year allowed ROE of 8.9% and the Commission approved a 9.3% ROE within the context of Niagara Mohawk's 3-year rate plan. Second, the Panel assumed a reasonable stay out premium for the 3-year Niagara Mohawk rate plan to be 30-40 basis points of the approved 9.3% ROE. Third, the $2.7 million annual premium provided in Niagara Mohawk's rates,[22] which serve as an inducement for Niagara Mohawk to "stay out" and not request new rates before the end of the three year rate plan, is worth approximately 30 basis points. Tr. 201-204; also, Hearings Exhibit 15, entitled "Calculation of Equity Return Effect of Stay Out Premium In Niagara Mohawk Power Corporation Gas Rates in Case 12-G-0202."

Given these factors, the Panel's analysis indicated that a reasonable currently allowed ROE upon which to determine National Fuel's earnings is in the range of 8.9% to 9.0% (i.e., 9.3% minus 30 -40 basis points) for a one year, litigated case.[23] Staff, therefore, recommended the use a 9.0% allowed ROE as the

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[22] Niagara Mohawk Order at 38-42. The Order states that the parties negotiated the Joint Proposal as a package and that the provisions, including the allowed ROE were reasonable in the context of the Joint Proposal. In accordance with the agreement, the Commission set a clawback provision, which requires Niagara Mohawk to return a specific dollar amount of $2.7 million to ratepayers if the utility files for new gas rates during the agreed upon rate plan. The clawback provision indicates that inherent to the 9.3% authorized ROE is a stayout premium.

[23] Since the May 23rd hearing, the Staff Panel in the Consolidated Edison rate proceeding (Cases 13-E-0030, 13-G-0031 and 13-S-0032) submitted testimony wherein the recommended an allowed ROE of 8.7%. The Staff recommended allowed ROE appears to be experiencing a downward trend since March 2013, when the Commission issued its Order for Niagara Mohawk. However, the Panel continues its position that a 9% ROE is a reasonable floor for the limited purpose of this exercise.

initial ROE endpoint. Tr.201 This recommendation should be accepted as reasonable and rationally based.

B. The Proper Measure for Determining Excess Earnings is Commission Currently Allowed ROE Authorizations

The Company did not recommend an allowed ROE for National Fuel. Tr.234 It, however, indicated that the Commission should compare its earned ROE to that of other utilities' earned returns to determine whether National Fuel's earnings are excessive. Tr.20-21; 233-243 While this type of comparison is not germane to the issue of reasonably determining the ROE deferential for National Fuel, and the relevance of the Company's argument is questioned, Staff will address these points so as not to be mistaken as conceding these points.

The Panel referred to this type of suggested comparison as essentially a comparable earnings approach. Tr.204 The Company incorrectly interpreted Staff's use of the word "approach" to mean that Staff considered National Fuel's testimony as a recommended ROE. Tr.204, 233-243 To eliminate this confusion, the Panel will refer to the Company's comparison of its earned return to that of other utility companies as a comparable earnings assessment.

As background, the Commission sets rates so a utility will have the opportunity to earn a reasonable required return that will enable it to attract capital. Tr.204 For example, if the market currently requires an allowed ROE of 9.0% and all major New York utilities are currently earning a 6.0% ROE, the Commission cannot reasonably set rates based on an allowed ROE of 6.0%, but should use the 9.0% ROE.

As shown by the above example, a comparable earnings assessment is susceptible to questioning. A comparable earnings assessment will not yield a reasonable allowed ROE in all circumstances. Also, earned ROEs reflect a company's earnings on its book equity and book equity does not have a direct link to what investors require on their investment. Tr.204-205

Further, the earned ROE for each utility company is largely a product of its rate plan, and, therefore, comparable earnings assessments are an inaccurate measure of how one utility company is performing relative to another. The Panel indicated that over the last three years there were only three instances for two companies, KeySpan Energy Delivery of New York (KEDNY) and O&R, where the earned ROE for a utility company was higher than National Fuel's earned ROE. Tr.240-241 Prior to applying KEDNY's ESM provisions, KEDNY's earned ROE for its rate years ended December 2010 and December 2011 was 13.98% and 14.10%,[24] respectively. After sharing, KEDNY's earned ROE was 11.85% for both years.[25] Compared to KEDNY's ROEs, National Fuel's earned ROEs were 11.10% and 11.25% for its fiscal years ended September 2010 and 2011, respectively. Tr.131, Hearing Exhibit 5, Schedule 1.

Again, while a comparison between KEDNY and National Fuel for rates years 2010 and 2011 are not relevant here, it is noted that there are two differences between KEDNY and National Fuel. First, the existence of the KEDNY's ESM capped its earned ROE, after sharing, at 11.85% in both 2010 and 2011 (ratepayers' share of its excess earnings for those years was $34 million and

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[24] Case 06-G-1185, The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York - Gas Rates, Amended KEDNY Earnings Report (dated July 21, 2011) and KEDNY Computation of 2011 Gas Rate of Return on Common Equity (dated May 29, 2012).

[25] Case 06-G-1185, The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York - Gas Rates, Order Adopting Gas Rate Plans for KeySpan Energy Delivery New York And KeySpan Energy Delivery Long Island (issued December 21, 2007).

$34.9 million, respectively). Second, KEDNY was towards the end of its rate plan. Although, the Commission has yet to approve the current KEDNY Joint Proposal, terms of that proposed agreement call for a two-year extension of KEDNY's rate plan, which will reduce KEDNY's sharing threshold from 10.5% (with 50% Ratepayer/ 50% Company sharing) to 9.4% (with 80% Ratepayer/ 20% Company sharing).[26] All other things being equal, National Fuel's ratepayers did not have an opportunity to share in any overearnings and KEDNY has subsequently agreed to both a lower ROE ESM threshold and greater ratepayer sharing effective from the end date of its rate plan. In other words, there no reason for the Commission to contemplate making KEDNY's rates temporary pending the permanent rate process, because the previous rate plan and newly agreed upon rate plan with a substantially lower ESM threshold and greater sharing was virtually seamless.

Concerning the third occurrence, O&R had an earned ROE of 12.62% for its rate year ended October 2012 for gas service.[27] National Fuel's comparative earned ROE was 12.41% for its year ended September 2012. Tr.131 However, O&R had an ESM of 11.4% that provided for the calculation of its earnings on a cumulative basis over the three years of its rate plan.[28] Since, O&R's average earned ROE over the three years of the rate plan was 10.79%[29], below the 11.4% threshold, its rate plan allowed it

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[26] Case 12-G-0544, The Brooklyn Union Gas Company d/b/a KeySpan Energy Delivery New York - Gas Rates, Joint Proposal (dated February 22, 2013), pp. 4-5.

[27] Case 08-G-1398 - Orange & Rockland Utilities, Inc. - Gas Rates, 2013 Gas Earnings Report (dated February 25, 2013).

[28] Case 08-G-1398, Orange & Rockland Utilities, Inc. - Gas Rates, Order Adopting Joint Proposal and Implementing a Three-Year Rate Plan (Issued and Effective October 16, 2009), pp. 6-9.

[29] O&R's earned ROE for the rate years ending October 2010 and 2011 was 10.2% and 9.55%, respectively.

to retain its 12.62% earned ROE for the third and final rate plan year.

To summarize, the Panel recommended that in evaluating National Fuel's future earnings, the Commission should employ an allowed ROE that will enable National Fuel to attract equity capital equity. Tr.204 Based on the recent Niagara Mohawk rate case, the Panel determined that, at this time, a reasonable allowed ROE is in the range of 8.9% to 9.0%, and recommended the greater 9.0% as a reasonable estimation. Tr.206

C. The Panel's Use of the Current Allowed ROE is Proper

There is Commission precedent for use of a current authorized ROE to determine earnings for a prior period. The Company implied that the Panel's use of the Niagara Mohawk allowed ROE to determine National Fuel's earnings for the year ended September 2012 is a mismatch because the Commission authorized the current allowed ROE after National Fuel's fiscal/historical year-end. Tr. 215-218. The Company also inferred that Staff should use a Commission authorized ROE that dates prior to October 2011, the start date of its historic year ended September 2012. Again, while the 2012 earnings of National Fuel is not relevant to inquiry of projected earnings for the twelve months ended May 31, 2014, the Panel's use of a current authorized ROE is consistent with Commission precedent.[30]

Specifically, the Commission stated in the O&R temporary rate proceeding[31] that:

> Orange and Rockland's recent earnings level indicates that its electric rates may be unjust, unreasonable, and higher than

[30] O&R Order, supra.

[31] Case 06-E-1433, Orange & Rockland Utilities, Inc. - Electric Rates, Order Instituting Proceeding and to Show Cause (issued December 15, 2006), pages 4-5.

> needed to provide safe and adequate service, particularly in light of the recent allowed ROE and sharing provisions established for other utilities.

In that case, the Commission determined O&R's earnings for three historic rate years, June 30, 2004, June 30, 2005 and June 30, 2006, based on then recent, Commission authorized allowed ROEs for NYSEG (Electric Rates) and O&R (Gas Rates). The ROEs for NYSEG of 9.55%[32] and O&R of 9.8%[33] were in effect after O&R's historic years ended. This is recent precedent for determining historic year returns based on current allowed ROEs. Accordingly, the Panel's use of such measure for National Fuel is appropriate.

Finally, the purpose of Panel's testimony and Hearing Exhibit 6 (TRP-3) is to quantify the amount by which National Fuel's recently reported earnings are in excess of the Commission's recently authorized returns for similar companies. In this proceeding, where the Panel is judging the reasonableness of National Fuel's rates prospectively, the use of the recent authorized ROE for Niagara Mohawk is not only appropriate, it is also more relevant than a Commission allowed 2011 ROE that it authorized prior to the start of National Fuel's historic year.

Therefore, Staff's use of the current 9.0% allowed ROE is an appropriate basis upon which to determine National Fuel's historic earnings.

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[32] Case 05-E-1222, New York State Electric & Gas Corporation - Electric Rates, Order Adopting Recommended Decision with Modifications (issued August 23, 2006).

[33] Case 05-G-1494, Orange & Rockland Utilities, Inc. - Gas Rates, Order Establishing Rates and Terms of Three-Year Rate Plan (issued October 20, 2006).

IV. STAFF ROE ADJUSTMENTS

A. Capital Structure

i. The Appropriate Equity Ratio to Determine National Fuel's Earnings for the Period Ending May 2014 is 48% (80 basis points)

The Company's testimony exhibited four variations of assumptions to show how it could calculate its earned return for the year ended September 2012. For the equity ratio, the Company assumed variations of 48%, 50% and 55%. Hearing Exhibit 3 (RLT-1, Schedule 2, Sheets 1-4). However, to calculate its projected earned return for the period ending May 31, 2014, the Company only employed a 55% equity ratio. Tr. 31-32; Hearing Exhibit 3 (RLT-1, Schedule 1, Sheet 1). The use of the 55% equity ratio is not reasonable or appropriate.

The Company calculated the 55% equity ratio by applying to NFG's consolidated capital structure a subsidiary adjustment similar to that employed by the Commission in the 2007 Rate Order.[34] Tr.32 The Commission, in that rate order, also assessed National Fuel's business risk relative to NFG and other utility companies in New York in determining the reasonableness of the resultant capital structure.[35] In this case, the Company only partially applied the Commission's methodology, since it did not conduct a business risk analysis/adjustment. Also, the Company's testimony did not indicate why the resultant 55% equity ratio is appropriate to determine National Fuel's earnings for the period ended May 2014.

The Panel reasonably determined National Fuel's capital structure by first applying a subsidiary adjustment to NFG's consolidated capital structure and then making an

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[34] 2007 Rate Order, supra.

[35] Ibid, pp. 33-36.

adjustment to reflect the difference in business risk between National Fuel, NFG and other companies.[36] Tr.193-197. The Panel's equity ratio methodology determined that at this time, a 48% equity ratio is a reasonable basis upon reach to calculate National Fuel's projected earnings for the period ending May 31, 2014. Tr. 186-197.

Given the above, the Commission should employ Staff's 48% equity ratio to determine the Company's projected earnings for the period ended May 2014. By replacing the Company's 55% equity ratio in the Company's cost of service projection with Staff's recommended equity ratio of 48%, National Fuel's projected ROE, for the twelve months ended May 31, 2014, increases by 80 basis points. Hearing Exhibit 4.

ii. <u>Staff's Equity Ratio Methodology Is Reasonable</u>

Staff conducted a two-step methodology to determine the 48% equity ratio upon which the Commission should calculate National Fuel's earnings for the period ended May 31, 2014. Tr. 186-197. The first step was the application of the Commission's subsidiary adjustment, wherein Staff removed the unregulated capital from NFG's consolidated capital structure based on a 60% equity/ 40% debt allocation. This resulted in a regulated capital structure reflective of a 57.1% equity ratio and a 42.9% debt ratio. Hearing Exhibit 10.

The second step was a risk adjustment based on the Standard & Poor's Ratings Services (S&P) business risk and

[36] The companies are the major transmission and distribution companies in NY. They are Central Hudson Gas & Electric Corporation (CHG&E), Consolidated Edison Company of New York, Inc (CECONY), KeySpan Energy Delivery - New York (KEDNY), KeySpan Energy Delivery - Long Island (KEDLI), Niagara Mohawk Power Corporation (NMPC), Orange & Rockland Utilities, Inc. (O&R), New York State Electric & Gas Corporation (NYSEG) and Rochester Gas and Electric Corporation (RG&E).

financial risk profiles for NFG and National Fuel relative to the other companies. NFG's S&P and Moody's credit ratings are BBB and Baa1, respectively. The compared companies' average S&P and Moody's credit ratings are A- and Baa1, respectively. See Hearing Exhibit 11, TRP-8. Since NFG issues debt for National Fuel, the credit rating agencies do not ascribe credit ratings to National Fuel. Moody's credit rating for NFG at Baa1 is equal to the average of the compared companies; however, S&P's credit rating for NFG is two notches lower than the average of the compared companies.

S&P ranks NFG's business risk and financial risk profiles as Satisfactory and Intermediate, respectively. This is consistent with its BBB rating, as determined in S&P's September 18, 2012, Ratings Direct article entitled "Methodology: Business Risk/Financial Risk Matrix Expanded" ("the Matrix Report"). Hearing Exhibit 12, TRP-9. S&P ascribes an "Excellent" business risk profile to National Fuel, however, ascribes to it no financial risk profile because NFG issues National Fuel's debt. Assuming that if rated, National Fuel would have a credit rating of "BBB", equal to that of its parent NFG, and given National Fuel's "Excellent" business risk profile, the Panel determined approximately where within the Matrix Report guidelines (Tables 1 and 2),[37] National Fuel's financial profile would occur. The guidelines indicated an aggressive financial risk profile, which is indicative of an equity ratio range of 50% to 40%. Tr.195

In addition, the Panel's data for the compared companies showed that relative to their average "Excellent" business risk profile, the individual companies' financial risk

[37] Matrix Report Table 1 (page 2) entitled "Business and Financial Risk Profile Matrix" and Table 2 (page 3) entitled "Financial Risk Indicative Ratios (Corporates)".

profiles ranged from Intermediate to Aggressive. Moreover, with the exception of KEDNY and KEDLI, the Commission had set rates based on a 48% equity ratio for each of the compared companies.[38] For KEDNY and KEDLI, the Commission had set rates based upon a 45% equity ratio. Tr.191 The Panel's recommendation to use a 48% ratio is reasonable, consistent with similar utilities, and ensures that National Fuel ratepayers' cost of capital rates are comparable to that paid by ratepayers of utility companies with similar business and financial risks. Tr.196

Given the above, as well as, National Fuel's reluctance to rebut the use of the Panel's 48% ratio or provide support for the use of its 55% ratio, the Commission should determine National Fuel's earnings for the period ending May 2014 be based upon a 48% equity ratio.

B. EB/Cap

In setting just and reasonable rates a utility is allowed to earn a fair return on the investor supplied capital dedicated to public service. The rate base used to calculate the fair return may be different then the investor supplied capital dedicated to public service. The purpose of the EB/CAP is to eliminate this difference. One of the reasons for this difference is that the so-called Federal Power Commission (FPC) method (1/8 of Operating and Maintenance (O&M)) used to compute

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[38] Niagara Mohawk Order at 25; Cases 09-E-0588 and 09-G-0589, Central Hudson Gas & Electric Corporation - Electric and Gas Rates, Order Establishing Rate Plan (issued June 18, 2010), Joint Proposal at Appendix H; Case 11-E-0408, Orange & Rockland Utilities, Inc. - Electric Rates, Order Adopting Terms of Joint Proposal, with Modification and Establishing Electric Rate Plan (issued June 15, 2012), pp. 11-12; and, Cases 09-E-0715 and 09-G-0716, New York State Electric & Gas Corporation. - Electric and Gas Rates, Order Establishing Plan (issued September 21, 2010), pp. 13-14.

the cash working capital allowance (CWC), which is included in rate base, may provide an imprecise formulaic allowance that does not consider the timing of all of the utility's cash flows in providing service that cause the need for this capital requirement.

Over time the Commission has entertained the two methods for calculating a company CWC need: a lead lag study and the FPC method using 1/8 of the company's O&M expenses. The Commission moved to use the FPC method in calculating the CWC component of rate base due to the complexities and controversy that developed around the use of lead lag studies. As mentioned above, since the FPC method is not precise the EB/Cap was developed as a check so the rate base reflected in the revenue requirement for setting rates equaled the investor supplied capital not earning a return elsewhere (for example Interest bearing CWIP accrues interest).

There is no disagreement as to the measurement of the $3.3 million EB/Cap for the historic test year ended September 30, 2012 in this proceeding. The disagreement instead revolves around the amount that should be reflected in the projected rate year ending May 31, 2014. It is the Panel's position that the historic test year amount be used in the determination of the rate year rate base. This is consistent with well established Commission practice. National Fuel instead would determine the rate year EB/Cap amount of $23.5 million based on the average EB/Cap for the two historic years ended September 30, 2013. The Company states a two year average is more appropriate considering the volatility of the EB/Cap over the last several years.

There is Commission precedent to use of the historic test year EB/Cap amount as the appropriate level of this adjustment to be reflected in the rate year rate base. This precedent is most clearly and consistently presented in the following Commission rate orders:

1.) Order issued December 1, 1980, Cases 27411 and 27681, Rochester Telephone Corporation-Telephone Rates (at page 36),
2.) Order issued March 12, 1981,Consolidated Edison Company of New York, Inc.-Electric Rates (21 NYPSC 701), and
3.) Order issued April 2, 1986, National Fuel Gas Distribution Corporation-Gas Rates (26 NYPSC 982).

In each of these decisions the Commission made clear the use of a three step approach to develop of the rate year EB/Cap amount,[39] and that the historic year difference between earnings base and capitalization is carried forward into the rate year. In these orders the Commission rejected adjustments to the historic EB/Cap in establishing the rate year amount. Also, in the Order issued on January 11, 1983 in Cases 28167, 28168 and 28169, New York state Electric and Gas Corporation Electric, Street Lighting and Gas Rates (23 NYPSC 50), the Commission made clear its general rejection of adjustment of the historic year EB/Cap in determining its rate year amount to be included in

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[39] As noted in the decisions, the usual procedure for computing the EB/Cap adjustment is as follows:

(1) The book values of non-utility assets paid for with investor-supplied capital are subtracted from the historic base year capitalization.

(2) The historic year earnings base (rate base plus interest-bearing construction work in progress) is compared to the adjusted capitalization. If the earnings base exceeds the capitalization, the excess is subtracted from the base year rate base.

(3) Projected additions to the earnings base between the base year and the rate year are added to the adjusted capitalization, reflecting an assumption that all plant additions are paid for with investor supplied capital.

rate base.[40] Finally, it should be noted that in Case 07-G-0141 National Fuel's gas rates were set following the above described EB/Cap three step procedure.[41]

In this proceeding, National Fuel is adjusting the historic year EB/Cap solely on the basis of the volatility of this amount over time. However, it identifies no changes in its operations between the historic and rate year that would affect the timing of cash flows that would be the basis of any such adjustment to the historic year EB/Cap. The mere fact that the EB/Cap amount can change over time does not provide sufficient support for deviating from well established Commission practice, as demonstrated above. Nor has the Company explained why using a two year average of the EB/Cap is appropriate and establishes the proper rate year amount. Instead it appears that the Company does not like the EB/Cap amount calculated in the historic year, so they want to change current EB/Cap practice to use a number more to their liking.[42]

The Company states that the rate making construct (EB/Cap adjustment) is flawed and not representative of the Company's cash working position, and that its cash working

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[40] For convenience, the pertinent EB/Cap sections of all four cited cases are attached as Attachment 1.

[41] It should be noted in the Company's last rate case, the witness testifying to the EB/Cap adjustment, applied the historic year EB/Cap adjustment to the rate year, with no modification, using the Commission's traditional EB/Cap computation. See, Case 07-G-0141 transcript at 1540. The Company's witness in that case is the same witness testifying in the current temporary rates proceeding case.

[42] The Panel further questions whether it would be appropriate or wise to consider to change established Commission practice during the temporary ratemaking portion of a potential permanent rate case where there has been limited discovery and party participation. Any such change with wide ranging ratemaking ramifications would be better considered in either a permanent rate case or generic proceeding.

position should be calculated using a lead lag study. Tr.96 However, in this temporary rates proceeding, the Company has provided no lead lag study, no calculation of the proper level of cash working capital, and no explanation of any change in its operations that would affect the cash flow for the projected rate year. It should be noted that in Case 07-G-0141 the Company claimed they calculated a lead lag for the cash working capital allowance, but did not use the lead lag for the cash working capital allowance in that case. The Company had agreed with the use of the 1/8 O&M cash working allowance and the EB/Cap method since the amount in the Rate Year would be similar to the combination of the FPC method and EB/Cap.

The Company claims there is volatility in the EB/Cap of other utilities (Hearing Exhibit 2, EHM-1, Schedule 2) as a basis to show that the historic year EB/Cap cannot be relied upon to set the rate year amount. However, the Company neglects to mention that in each of the proceedings setting the rates for these New York utilities the rate year EB/Cap was based on the historic year measurement consistent with the Commission precedent cited above. In fact, the Company provided no Commission precedent to show that such an unsupported averaging adjustment of the historic year EB/Cap was appropriate in determining the rate year amount.

National Fuel's rebuttal testimony criticizes Staff use of the historic EB/Cap since this is not a rate case. The Company claims they were ordered to provide calculations of earnings for the TME May 31, 2014, however their forecast was not done as if it was a rate year. Since the Company claims this is not rate case, the Company advocates the use of the EB/Cap from Case 07-G-0141, or until the time rates are changed. The Panel disagrees with National Fuel's characterization of this proceeding. This is a rate setting exercise because its purpose is to determine if the Company's current rates are reasonable based on its projected levels of revenues, expenses and investment. In fact, this is what the Commission required when in the order instituting this proceeding it ordered National Fuel to provide its projected cost of service schedules for the projected rate year ending May 31, 2014.

Further, the Company's own exhibits start with the Historic Year Ended September 30, 2012 and project the rate year the TME May 31, 2014. Many of the Company's adjustments are done similar to in a rate case. The Company starts with the historic test year, revenues, expenses (cost elements), taxes other than income taxes, rate base and income taxes. Adjustments are made to these historic amounts, for example inflation is applied to many cost elements and property taxes to arrive at forecasted rate year levels. The Company's rate base is increased for net additions and deferred taxes similar to the way it would be computed in a rate case. Based on this it would be inconsistent to use the EB/Cap amount when rates were last set in 2007 as the proper measure of the level of EB/Cap for the projected rate year ending May 31, 2014 because it would not reflect the current levels of cash flows from utility operations. The most current level is better represented in the EB/Cap measurement for the historic year ended September 30, 2012 and its use in the rate year would be consistent with the Commission practice.

In summary, the Staff's historic year based EB/Cap adjustment should be accepted because it is consistent with Commission practice. The Company has not justified why a change in policy is warranted now, nor how has it detailed how its operations would change between the historic and rate year in this proceeding that would obviate the use of the historic year EB/Cap. National Fuel provides no basis to demonstrate that a two year average is the more appropriate level of this adjustment for the twelve months ending May 31, 2014.

C. Property Taxes

The Company forecasted the rate year ending May 31, 2014 property tax expense of $$29.5 million by applying the 1.75% annual general inflation factor to the historic test year ended September 30, 2012 property tax expense of $28.6 million. Company witness Truitt acknowledged the historic trend of decreasing property tax expense, but believes the decreasing trend in property tax expense is coming to an end. From 2006 through 2012, National Fuel has received increasing Economic and Functional Obsolescence awards from NYSORPS. The Company alleges that obtaining additional awards from NYSORPS may be difficult and other efforts it has taken to control this cost will be overcome by increasing tax rates from the taxing jurisdictions and assessment growth due to continuing construction. As support for the change in the trend of tax expense in her direct and rebuttal testimony Company witness Truitt presented anecdotal information from news articles in the Buffalo area reporting various taxing jurisdiction budget increases that would affect the level of property tax paid by NFG in the forecasted rate year ended May 31, 2014. She also noted the 1.77% increase in NFG's 2013 town and county property tax payments.

The Panel found that based on the five fiscal years ended September 30, 2012, National Fuel's property taxes have experienced an average annual reduction of 1.23% (Tr. 162 pg 49 of TRP). This downward trend in property tax expense continued through the year ended March 31, 2013. It also pointed out that despite the Company's claim of flattening obsolescence awards National Fuel received an increased functional obsolescence award from the ORPTS for the 2013 assessment roll that was not disclosed in Company Witness Truitt's testimony. Tr.161 Even though the downward trend in property taxes continued through March, 2013, and obsolescence awards are increasing on those rolls used to set the rate year property taxes, the Panel did not forecast a decrease in its rate year property tax expense. The Panel instead used the historic test year actual property tax expense as a proxy for the rate year property tax expense, thus reflecting a conservative estimate.

The Company makes a valid point that the amount of property taxes that NFG incurs is effected by a number of variables including the taxing jurisdiction's budget and the assessed values of the property in the taxing jurisdiction to derive the tax rate (Tr.99), and ultimately by the level of the assessed value of National Fuel's properties that when multiplied by the tax rate determine the property tax bill for the Company. While the Company has focused on those variables that indicate a potential increase in property tax for National Fuel, it has neglected others that could have an offsetting effect.

The Company only reports on increases in taxing jurisdiction budgets, but doesn't provide any indication on the change in assessed properties for these taxing jurisdictions that can affect the level of the tax rate. Also, the Company neglects to consider that the increase in the functional obsolescence award received from ORPTS that applies to 95% of NFG's properties will continue to reduce the assessed values of National Fuel's taxable properties, thus producing a downward pressure on the Company's taxes in the rate year. This is evident when Company witness Truitt cited the increase in the Company's 2013 Town and county tax payment as basis for her claim that the overall rate year property tax expense of the

Company would increase. She agreed that this tax was based on the 2012 assessed values of the Company. There is a year's lag between the assessment roll and the tax upon which it is based. Tr.103 Based on this lag, all of remaining property tax payments for tax jurisdictions covering the fiscal years ending June 30, 2014 or calendar year 2014 and expensed in the forecasted rate year will be based on the 2013 assessed values of National Fuel's properties which would be reduced by the increased functional Obsolescence award from NYSORPTS mentioned above.

Further, according to company witness Truitt (Tr.84) the previous functional obsolescence applications have addressed medium pressure mains, and for the first time the Company obsolescence application this year will also include low pressure lines. Functional obsolescence applications, which were only for transmission and distribution mains, will now include low pressure lines and be applied on over 95% of the total system. Tr.85 This Company action appears inconsistent with the position that maintaining the current level of obsolescence awards may be difficult, because at the same time they will be applying for additional obsolescence awards on an additional category/class of assets. The amount of obsolescence awards received in the future could in fact be higher than the current level, and might contribute to a possible continued downward trend in property taxes.

In considering National Fuel's projection in this proceeding it is instructive to note that the Company used the same approach to justify its forecasted rate year property tax expense request in Case 07-G—0141. In that case, the Company requested a rate year (Calendar 2008) property tax expense of $32.068 million, or 3.6% over the historic test period (TME

2006) actual property tax expense. The Company supported its requested property tax allowance by citing a litany of reasons:

1. Proposed increases in Erie county taxes will rise by as much as 5.7%. About 70% of the Company's property tax payments go to taxing jurisdiction in Erie County.

2. The Company believed that property tax re-evaluations were expected to increase taxes by 3.0% and the tax rate was expected to rise by 2.7%

3. The Company claimed that the fiscal problems besetting the City of Buffalo will cause property taxes there to rise substantially in excess of the amounts experienced in recent years.

4. Finally, the Company claimed that the use of a five year average of percentage increases, Staff calculated a 3.07% average, was lower than what might otherwise have been had it not been successful in tax certiorari and other tax challenges.

From all the Company arguments in that case, it would appear that property tax expense should have risen significantly. This is not the case. The reality is that actual property tax expense for Calendar 2008 was $29.096 million, or $2.972 million lower than the Company's forecast. Not only was the 2008 rate year actual property tax expense 9% lower than the Company's rate case forecast, the actual 2008 property tax expense was lower than the historic test year (TME September 30, 2006) amount of $29.495 million.

National Fuel is continuing its trend of receiving higher obsolescence awards from the NYORPS into the 2013 assessment roll that will have a downward effect on the property taxes in the rate year. However, Staff recognizes that there are also potential upward pressures on this cost. Based on these countervailing factors, Staff recommends the historic fiscal year (TME 9/2012) property tax expense of $28.615 million be carried forward as the amount of property tax expense for the twelve months ended May 31, 2014. The Panel's projected rate year property tax expense reduced the Company rate year request by $0.839 million, from $29.454 million to $28.615 million. This adjustment is reflected in Staff's projected cost of service for the twelve months ended May 31, 2014, presented as Hearing Exhibit 9, and has the effect of increasing the projected earned return on equity by approximately 17 basis points.

D. Productivity

In its filing, the Company did not include a productivity adjustment in its projection for the twelve months ended May 31, 2014, nor did it provide any testimony as to why this adjustment was inappropriate. In its preliminary review of the Company's projections, Staff recommended an imputation of the Commission's traditional 1% productivity adjustment be made. Staff's makes this adjustment to capture the unknown, unidentified, and unquantified efficiencies the Company is expected to realize in the projected twelve month period. The adjustment is based on 1% of projected labor expense costs, fringe benefits and payroll taxes. Staff quantifies the 1% productivity to be $0.8 million, increasing the Company's projected earned ROE 9.22% by 15 basis points. Tr.164-165

While the Company provided no rebuttal testimony to Staff's productivity adjustment, it seems to disagree with the adjustment based on the amount of productivity that has been achieved since rates were last set in 2008. Tr.226-227 While the Company is commended for the productivity it has achieved in the past, this is irrelevant when projecting the appropriate level of O&M expenses for the future, especially taking into consideration the Company's projection of an 8% labor expense increase and 23% health care cost increase for the 20 month period from the end of the historic period, September 30, 2012, and the twelve months ended May 31, 2013. Tr.172-173

As Staff indicates in its testimony, imputing the 1% productivity adjustment is necessary to recognize the impossibility of specifying all rate year productivity improvement in advance. Tr.165 Furthermore, the imputation of the 1% productivity adjustment is supported by the Commission's opinions in the O&R Order (at 9), Case 29541, New York State Electric and Gas Corporation, Opinion 88-2, Opinion and Order Determining Revenue Requirement and Refunding Excess Earnings (issued January 20, 1988) and Case 95-G-1034, Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of Central Hudson Gas & Electric Corporation for Gas Service, Opinion No. 96-28, Opinion and Order Concerning Revenue Requirement and Rate Design (issued October 3, 1996).

Staff's recommended imputation of the Commission's traditional 1% productivity adjustment is reasonable and should be taken into account when determining the reasonableness of the Company's O&M expense projection and the resulting 9.22% projected earned ROE. Staff productivity adjustment increases the Company's ROE by 15 basis points.

E. Net Plant Forecast

The Company took the gross plant balances as of September 30, 2012 and forecasted the monthly additions and retirements through May 31, 2014 with Construction Completed Not Classified (CCNC) and Non Interest bearing Construction Work in Progress held constant at the September 30, 2012 balances of $8,376,000 and $363,000, respectively. The Company used the same approach to forecast the Reserve for Depreciation by estimating monthly accruals, retirements and salvage. As shown on Hearing Exhibit 3, RLT-2, Schedule 4, Sheet 2, the Company's projected average net plant is $794.624 million for the twelve months ending May 31, 2014.

The Panel had two adjustments. National Fuel has not opposed either adjustment. In the net plant calculation, the Company used a beginning gross balance of $1,249.715 million, which includes the CNCC balance of $8.376 million. In Hearing Exhibit 3, RLT-2, Schedule 4, Sheet 2, the Company added the CCNC balance of $8.376 million to its total net plant calculation. The Panel, therefore, believes that the CCNC balance is mistakenly added twice in the Company's net plant calculation. Therefore, the Panel proposed a downward adjustment to the Company's net plant balance by $8.376 million to correct this error.

The Panel also corrects a discrepancy between the Company's annual depreciation expense and the Reserve for Depreciation Accruals. In the Company's workpapers, Hearing Exhibit 3,RLT-2, Schedule 4, Workpaper at pg.1, the Reserve for Depreciation reflects annual accruals of $32.278 million, while the Company claims an annual depreciation expense of $33.985 million - a difference of $1.707 million. As shown in Hearing Exhibit 3, RLT-2, Schedule 2, Workpapers at p.26, the Company reclassified $1.707 million of "Transportation Clearing" as depreciation expense; however, its annual depreciation accruals do not reflect this adjustment. We propose to adjust the net plant downwards by approximately $1.707 million.

The Panel quantifies the two adjustments totaling a reduction of $10.083 million to the Company's net plant forecast, which in turn increases the Company's projected ROE by 19 basis points. This adjustment is reflected Hearing Exhibit 9. Again, National Fuel has not rebutted or cross -examined the Panel on these two net plant forecasts corrections, and, therefore, Staff believes this recommendation should be accepted.

F. <u>Medicare Subsidy Income Tax Deduction</u>

The Medicare Act of 2003 established a tax-free subsidy for a portion of an employer's annual prescription drug costs. The non-taxable status of the subsidy provides a tax benefit to utilities. The Commission ordered, in Case 04-M-1693, that utilities defer the tax benefit and then pass these tax benefits back to ratepayers in rates. Tr.169 In the historic test period ending September 30, 2012, the Panel found that the Company recorded a $0.444 million credit in other operating revenues, which reflected the amortization of this deferral of the tax benefit owed to ratepayers, as well as, reflecting a $0.444 million deduction in its income tax calculation for this same period for this tax benefit. This accounting results in excluding the other operating revenues from income taxation so that its full amount of the $0.444 million amortization flows to earnings, and also results in the same earnings effect as the accounting for the return of the tax benefit to ratepayers as described above in the 2007 Rate Order. However, the Company did not continue this accounting, as it should have, in its projection of the twelve months ending May 31, 2014. Tr. 170.

Due to the fact there is a sufficient deferral balance in the account available to provide for the amortization through and beyond the projected rate year ending May 31, 2014, the Panel recommended an adjustment be made to increase the projected revenues by $0.444 million, increasing the projected earnings by 9 basis points. Tr.171-172 The Company has not rebutted the Panel on this issue; therefore, the Panel believes its calculation is correct, and this recommendation should be accepted.

V. DEFERRALS

In the OTSC, the Commission discussed certain expenses National Fuel is deferring that will be recovered from customers in the future. National Fuel is allowed to defer the difference between its actual costs and the rate allowances for Other Post Employment Benefits (OPEBs), and Site Investigation and Remediation (SIR) expenses. In addition, in the 2007 Rate Order, the Commission allowed National Fuel to accrue a non-cash return on the internal reserve pension debit balance at a rate equal to the actuarial assumed long run return on pension plan assets. The internal reserve pension debit balance reflects amounts that are funded into the external pension fund that exceed the rate allowance for pension costs. The return, or otherwise referred to as carrying charge amount, that has accrued since the last rate case reside in a deferred debit account on the Company's books, and are also subject to recovery from customers at some future time period. Tr.209-210

The deferral balance as of September 30, 2012 totals $25.797 million of deferred debits to be recovered from customers, and is comprised of: $1.337 million for pension expense, $9.290 million for OPEBs expense, $2.477 million for SIR expense, and $12.693 million for the accrued carrying charges for the internal reserve pension debit balance. In addition, although it is not yet recorded on the Company's books, there is an incremental SIR expense amount of $6.120 million, plus carrying charges, which will be due the Company as a result of a New York State Court of Appeals decision that reverses the 2007 Rate Order determination concerning SIR insurance proceeds.

It is expected that the deferral for the above specific cost items will continue in 2013. Based on actuarial information for pension and OPEB costs, Staff projects an additional pension expense deferral of $8.2 million and a credit to the OPEB expense deferral of $(1.4) million, for the fiscal year ended September 30, 2013. In addition, there are additional carrying charges of approximately $2.5 million that will likely accrue for the return allowed on the internal reserve debit balance. Excluding the incremental SIR expense amount of $6.120, the projected deferred debit balance will rise to $35.099 million as of September 30, 2013. Tr.211-212

In its rebuttal testimony, National Fuel indicates there are additional deferrals that reside on its books that Staff did not mention. Specifically, there is a deferred credit balance of $1.437 million for the Research, Development and Demonstration deferral, as well as a credit balance of $9.803 million for the low income LICAAP program. Tr.101 While the Company is correct that the Panel did not include these in the cited deferral balances, it is important to note that the LICAAP deferred credit does not get treated in the same manner as the remaining deferrals. This specific deferred credit can only be used to fund low income program expenses, and, therefore, is not available to offset the remaining deferrals. Therefore, even after crediting the $1.437 million, the significant projected deferred debit balance of $33.662 million to be collected from ratepayers remains.

VI. CONCLUSION

Conservatively, if current rates are not frozen subject to refund prior to the permanent rate portion of this proceeding, National Fuel ratepayers will lose the benefit of over $10 million. The Panel's conservative forecast that

National Fuel will have an ROE in excess of 11% for the twelve months ended May 31, 2014 is reasonable and supported. Further, the Panel's estimation that the currently allowed ROE is 9.0% is reasonable and rationally based. This 200 basis point differential equates to $10.3 million in rates that the Panel believes to be unreasonable and not necessary for the provision of safe and adequate service. The ROE differential, along with the continuation of increasing deferrals owed by ratepayers, is more than adequate for the limited purpose, at this stage of this proceeding, to freeze current rates subject to refund. The Company has not demonstrated that it will be harmed by such a rate freeze which will serve to protect ratepayer interests during the permanent rate process.

Therefore, it would be in the public interest, in accordance with PSL §114, to review National Fuel's permanent rates by freezing current rates subject to refund at this time.

Respectfully submitted,

S/

John Favreau
Staff Counsel

Dated: June 6, 2013
Albany, New York

ATTACHMENTS

June 3, 1981

Consolidated Edison Company of New York, Inc.

Case 27744

Commissioners present:
Paul L. Gioia, *Chairman*
Carmel Carrington Marr
Harold A. Jerry, Jr.
Anne F. Mead

Electric Rates

Order Denying Reconsideration

BY THE COMMISSION:

By our Opinion No. 81-4, issued March 12, 1981, we authorized Consolidated Edison Company of New York, Inc. (Con Edison or the company) to increase its rates for electric service by 15.5 percent. Petitions requesting reconsideration of various aspects of that decision have been filed by the New York State Consumer Protection Board (CPB); the New York City Department of Consumer Affairs (DCA); the Department of Law (DOL); the Borough of Manhattan; the Simpson Street Development Association (Simpson Street); and the New York City Transit Authority (TA). Responses to all petitions have been filed by Con Edison, and Department of Public Service staff has also responded to TA's petition. DOL and DCA, finally, have replied to Con Edison's response, but these pleadings are nowhere authorized by our rules, and DOL and DCA have failed to show good cause for waiving them.[1]

The petitions for rehearing have been reviewed in light of Section 2.8(a) of our rules of procedure,[2] which require such petitions to "set forth separately each error of law and fact alleged to have been made by the Commission in its determination and the facts and arguments in support thereof." We remind the parties that petitions for rehearing are not to be used to reargue points that were not adopted unless the failure to adopt a point is demonstrably erroneous; nor should they raise new issues of a factual nature that could have been raised during the evidentiary hearings. DCA has presented a number of new statistical exhibits and arguments; and while we find they are legally irrelevant and factually erroneous on their face, under Section 2.8(a) they are not admissible now at all. They are not, accordingly, discussed any further in this order. DOL has also presented a number of arguments and opinions of a factual nature

FEDERAL INCOME TAXES

Deferral of Tax Preferences

Simpson Street argues once again that our decision "erroneously and unlawfully includes and approves an allowance for Deferred Taxes and the continued maintenance of accumulated Deferred Taxes by the company."[10] For the most part, Simpson Street has merely repeated arguments that we have already considered in this and other cases. To these arguments, Con Edison responds that there are "many judicial decisions holding that the Commission is not required to use any particular formula or methodology in the determination of just and reasonable rates."[11]

Simpson Street next argues that our decision to defer reconsideration of our policy permitting electric utilities to normalize certain tax preferences until after the conclusion of the generic financing proceeding is erroneous because "the Commission duty to set just and lawful rates exists in this case, rather than in a generic proceeding."[12] Con Edison responds that "[g]iven that normalization was authorized in a Policy Statement applicable to all companies and that the limitation or expansion of tax normalization is but one of the several interrelated issues affecting the ability of the New York electric companies to finance their construction requirements, the Commission was right to conclude that Simpson Street's generic attack on tax normalization should be presented in the generic proceeding instituted by the Commission to consider such issues."[13]

Simpson Street's arguments continue to miss an essential point. Broadly stated, our goal is to authorize the lowest rates that will permit the continuous provision of safe and adequate service. The achievement of this goal requires recognition of the fact that many factual and policy issues may be interrelated and thus cannot usefully be examined in isolation, and the generic case is examining many interrelated policy and cost issues. Parties to rate cases are, of course, free to demonstrate, with evidence, that a particular policy is not cost-effective, but Simpson Street has not done so, and has failed to demonstrate that our decision is wrong.

Finally, Simpson Street contends we erred by failing to rule on its motion to compel Con Edison to produce certain evidence concerning its deferred taxes. But its interlocutory appeal of the Administrative Law Judge's denial of its motion was dismissed by a one-commissioner order issued November 3, 1980, and Simpson Street did not renew its motion in its brief on exceptions.

Accordingly, Simpson Street's request for reconsideration is denied.

RATE BASE

Earnings Base/Capitalization Adjustment

DCA has essentially reargued its position that the earnings base/

capitalization adjustment employed here should be based on its witness' projection of the size of the adjustment itself, instead of the step-by-step historic year-to-test year adjustment normally employed by us and proposed by staff in this case. But DCA has not refuted our finding that its witness' projection rests on an unsubstantiated calculation; and, therefore, it obviously cannot contend that our refusal to rely on an unsubstantiated projection is erroneous or unlawful. Accordingly, DCA's request for reconsideration is denied.

Land Held For Future Use

CPB, raising two arguments, seeks reconsideration of our inclusion in the company's rate base of certain parcels of land held for future use. First, CPB contends Con Edison has not provided a reasonably definite plan for the land, as required by the criteria for land retention set forth in our August 1, 1980, Order Concerning Revision of Policy. But we concluded, on the basis of the record, "that Con Edison has a long range plan, and a fairly detailed one at that."[14] CPB has not demonstrated that this finding is in any respect erroneous.

Second, CPB claims that including in rate base parcels of land that may not be used for more than 20 years conflicts with our general policy of not allowing plant under construction in rate base. But this argument forgets that realty, by its very nature, is unique in character (unlike most plant), and certain features of a given parcel, such as its location and suitability for utility operations, may make long-term advance acquisition prudent.[15] We gave determinative weight to *both* the company's plan and the valuable locations of the parcels at issue, and CPB has failed to demonstrate any error in this determination. Accordingly, its request for reconsideration is denied.

RATE OF RETURN

Equity Ratio

CPB and DCA seek reconsideration of our decision refusing to employ anything other than the company's projected actual equity ratio in the rate of return computation. Neither party, however, has sponsored any evidence that supports their allegations that the company's equity ratio bespeaks "imprudent financial policies." Instead, each party continues to emphasize the *amount* of equity ratio relative to those of other companies; but, as we said in our Opinion, such comparisons, standing alone, prove nothing. Accordingly, CPB's and DCA's request for reconsideration are denied.

Cost of Equity

CPB's and DCA's return on equity presentations were summarily

March 12, 1981

Consolidated Edison Company of New York, Inc.

Case 27744

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Commissioners present:
Charles A. Zielinski, *Chairman*
Edward P. Larkin
Carmel Carrington Marr
Harold A. Jerry, Jr.
Anne F. Mead

Electric Rates

Opinion No. 81-4

Opinion and Order Determining
Revenue Requirement

Appearances: See Appendix A

BY THE COMMISSION:

On April 18, 1980, Consolidated Edison Company of New York, Inc. ("Con Edison" or "the company") filed tariff revisions designed to increase annual electric revenues by $449,481,000 (15.5 percent) for the year ending March 31, 1982. By various orders we suspended the effective date of the proposed revisions through March 14, 1981.

Twenty-two days of hearings were conducted between June 9 and October 6, 1980.[1] Commissioner Carmel Carrington Marr and Administrative Law Judge Frank S. Robinson presided at the first two hearings,

RATE BASE

Earnings Base/Capitalization Adjustment

One analysis undertaken in the process of determining a company's revenue requirement is the earnings base/capitalization adjustment. Our usual procedure for computing the adjustment, which staff used in this case, is as follows:

1. The book values of nonutility assets paid for with investor-supplied capital are subtracted from the historic base year capitalization.
2. The historic year earnings base (rate base plus interest-bearing construction work in progress) is compared to the adjusted capitalization. If the earnings base exceeds the capitalization, the excess is subtracted from base year rate base.
3. Projected additions to earnings base between the base year and the test year are added to the adjusted capitalization, reflecting an assumption that all plant additions are paid for with investor capital.

The purpose of the earnings base/capitalization adjustment is to insure that a return is authorized on investor-supplied capital only. One of the reasons for the adjustment is that the FPC method of computing the cash working capital allowance included in rate base, which we employ in preference to complicated and time-consuming lead-lag studies, may provide an excessive allowance because it fails explicitly to take into account items such as accounts payable and taxes and interest collected in rates but not yet paid out.

Three questions are presented concerning the earnings base/capitalization adjustment in this case, which staff and the Judge calculated in accordance with the procedure set forth above.

1. *Use of Historic Earnings Base*—DCA contends that the earnings base/capitalization adjustment should be based on the forecasted earnings base rather than the historic one. In support of its position, DCA raises many of the same arguments that were raised by the utility and rejected by us in the recent *Rochester Telephone* case,[35] including the following:

a. An adjustment based on future conditions will of necessity be more precise and more equitable than an adjustment based on conditions in 1979.

b. Beginning the adjustment with an historic earnings base is not consistent with the policy statement on forecast test years.[36]

c. Basing the adjustment on projected data will more accurately reflect the true trend (however the parties may interpret it) in the adjustment.

Our response to these arguments in the *Rochester Telephone* Opinion was as follows:

> [Rochester Telephone] argues first that staff's entire approach to the earnings base/capitalization adjustment, which staff on exceptions urges us to adopt, is incorrect as a matter of policy because our policy statement on forecast test years requires that the adjustment be calculated using forecasted data. We disagree. Our policy statement says that "major plant additions from the end of the historic period should be separately identified," and staff's method does nothing less than this. Staff's method also produces a projection of the test year capitalization devoted to financing utility plant, as our policy statement requires. The company appears to object to the fact that this projection of additional capitalization precisely follows the rate base forecast, but the record shows that the company has not presented a better forecast. In fact, as staff points out, the company's projected capitalization includes an increase exceeding $8 million, which the company attributed, without substantiation, to "miscellaneous assets." The company argues that its use of this unsubstantiated addition to its projected book assets provides no basis for criticism of its approach because, it claims, that number merely balances historic year current assets with projected test year current assets determined by employing the FPC method for computing cash working capital. But this argument, not staff's criticism, misses the point. As we said earlier, the very purpose of the earnings base/capitalization adjustment is to avoid the overstatement of the test year rate base that can frequently result when the FPC method is employed. To use an unsupported capitalization, as the company recommends, would thus clearly defeat the purpose of the adjustment.[37]

Here, too, the earnings base/capitalization adjustment based on projected data ultimately must rest on an unsubstantiated calculation, because it lacks the relative precision of staff's step by step approach. DCA's adjustment depends heavily on its witness' estimates and assumptions concerning the extent to which certain current balance sheet ratios and inputs into the working capital formula will change between now and the end of the rate year; but these estimates and assumptions are even less supported than Rochester Telephone's "miscellaneous assets" account.

Judge Robinson thus had ample justification for concluding that our usual method for calculating the earnings base/capitalization adjustment produces a comparatively better projection. Accordingly, DCA's exception is denied.

Notwithstanding our conclusion, we acknowledge that DCA's presentation, although imprecise, does point out one aspect of our usual earnings base/capitalization adjustment methodology that may require re-examination, namely, the assumption that rate base additions between the historic base year and the rate year are entirely investor-supplied. This assumption, however, may not always hold true. In future proceedings, therefore, we shall entertain proposals for a method, which should be relatively easy to apply, for estimating the portion of the rate base increase that is likely to be financed by sources of funds that require no return.

2. *Amount of Temporary Cash Investments*--The question presented here is the narrow one of whether staff improperly computed the amount of temporary cash investments to be deducted from the company's capitalization. The issue next discussed is whether, computations aside, a portion of those investments should be included in capitalization to support a cash allowance over and above the working capital allowance.

Staff computed the average daily temporary cash investments balance, while Con Edison advocates using the average monthly balance; Judge Robinson adopted staff's position. According to staff, the balance fluctuates significantly from day to day, reflecting receipts from customers and payments of expenses, and the average daily balance is thus a more accurate number. Con Edison does not contend otherwise, but it claims that use of the daily balance in the earnings base/capitalization adjustment is not proper because the various rate base accounts are computed using monthly balances. Thus, the company claims, projected earnings base additions that are financed by temporary cash investments might be recorded at a dollar amount that is lower than the amount by which the investments balance was reduced. This objection assumes particular importance, the company contends, because its temporary cash investments balance is on a downward trend.

In response, staff observes, first, that other components of capitalization that can be computed on a daily balance basis are so computed; and, second, that the company's claims that its investments balance is declining is not supported even by its preferred measure of monthly average balances. Staff also points out that the rate year earnings base and capitalization will adequately reflect all plant additions, even if they are financed by temporary cash investments.

The claimed downward trend in the temporary cash investments balance is of no relevance to the question of whether it is proper to use a

April 2, 1986

National Fuel Gas Distribution Corporation

Case 29088

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BY THE COMMISSION:

INTRODUCTION

On May 10, 1985, National Fuel Gas Distribution Corporation (NFG or the company) filed revised tariff leaves designed to increase annual operating revenues by $35.1 million, a 5.3% increase. By various orders, we suspended the proposed tariff revisions through April 7, 1986.

NFG's most recent previous rate case resulted in a revenue increase of $15.2 million, effective December 28, 1983. In this utilities' insurance costs, and we shall expect the utilities to be prepared to demonstrate, in future rate proceedings, that they have undertaken all reasonable efforts to contain their insurance costs, including, but not limited to, studying the feasibility of self-insurance and the cost-effectiveness of establishing an industry mutual liability insurer.

RATE BASE

Earnings Base/Capitalization Adjustment

One analysis undertaken in the process of determining a company's revenue requirement is the earnings base/capitalization adjustment. The usual procedure for computing the adjustment, which NFG initially employed in this case, is as follows:

1. The book values of non-utility assets paid for with investor-supplied capital are subtracted from the historic base year capitalization.
2. The historic year earnings base (rate base plus interest-bearing construction work in progress) is compared to the adjusted capitalization. If the earnings base exceeds the capitalization, the excess is subtracted from the base year rate base.
3. Projected additions to the earnings base between the base year and the rate year are added to the adjusted capitalization, reflecting an assumption that all plant additions are paid for with investor-supplied capital.

The purpose of the earnings base/capitalization adjustment is to insure that a return is authorized on investor-supplied capital only. One of the reasons for the adjustment is that the so-called FPC method of computing the cash working capital allowance, a relatively simple formula that is employed instead of complicated and time-consuming lead-lag studies, may provide an excessive allowance, because it fails explicitly to take into account items such as accounts payable and taxes and interest collected in rates but not yet paid out.

Despite starting out on the right track, NFG argued for the first time in its initial brief to the Judge that the entire earnings base/capitalization adjustment should be recalculated on the basis of its fiscal year 1985 financial data. NFG's argument was unaccompanied by any such recalculation. Judge Vernieu rejected NFG's position, pointing out that there is no such thing as

a "simple" update of the earnings base/capitalization adjustment, because both sides of the balance sheet must be completely reexamined. The Judge concluded that NFG was arguing for a "wholesale revision" to its rate filing without demonstrating that major events beyond the company's control have altered or will alter its financial position.

NFG excepts, repeating the arguments it made to the Judge. Staff opposes NFG's exception, endorsing the Judge's conclusions and pointing out that the revenue requirement update set forth in the company's brief on exceptions still did not include any recalculation of the earnings base/capitalization adjustment.

NFG is advocating a position that we considered and rejected in two previous cases, once when it was advocated by a utility[72] and once when it was proposed by an intervenor.[73] We continue to endorse our existing practice. Accordingly, NFG's exception is denied.

Rate Base Associated with Purchases of Locally-Produced Natural Gas

In its brief on exceptions, staff contends that NFG did not purchase any locally-produced gas from Paragon Resources in September 1985. Staff argues that we should ascertain whether or not this alleged cessation of purchases has continued; if it has, staff continues, we should take the following actions:

1. Direct NFG to provide information about the net capital cost of any service well lines and field lines used exclusively to move gas purchased from Paragon, with a view toward excluding it from NFG's rate base.
2. Direct NFG to eliminate from its projected rate base the working capital allowance for prepayments to Paragon ($631,000) or justify retaining it.
3. "[P]ut NFG on notice that if it is ultimately determined that NFG's purchases from Paragon during the rate year and thereafter prove to have warranted adjustment to NFG's rates, NFG will be required to recompense its ratepayers accordingly."[74]

NFG, responding to staff, contends that no gas plant is going unused, because (1) both Paragon and non-Paragon gas is

70 NFG's base rates were increased annually from December 1980 through December 1983. The base rate increase at issue here would be NFG's first in 27 months.

71 We are prepared to help the company achieve and maintain a reduction in the frequency of its general rate applications. To this end, we invite the company to submit a proposal for an "expanded" second stage that would supplant a full-scale general rate case. For guidance, the company might refer to our decisions in the most recent New York Telephone and Brooklyn Union rate cases. Case 28961, *New York Telephone Company-Telephone Rates, Statement Concerning Plan to Postpone New General Rate Cases* (issued March 19, 1986); Case 28947, *supra*, Opinion No. 85-15, mimeo pp. 34-40 and Appendix C.

72 Case 27681, *Rochester Telephone Corporation–Telephone Rates*, Opinion No. 80-38 (issued December 1, 1980).

73 Case 27744, *Consolidated Edison Company of New York, Inc.–Electric Rates*, Opinion No. 81-4 (issued March 12, 1981, 21 NY PSC 673.

74 Staff's Brief on Exceptions, p. 34.

75 CPB does not argue for adoption of its projection of National Fuel Gas Company's equity ratio, because its position is that an *imputed* equity ratio should be adopted for ratemaking purposes, regardless of whose forecast is adopted.

76 R.D., p. 1113.

77 CPB's exception is also granted, to the extent that it is consistent with staff's.

78 *E.g.*, Case 28447, *supra*, Opinion No. 83-26, 23 NY PSC 6175.

79 That is, the dividend investors expect to receive over the next 12 months divided by the current share price, expressed as a percentage.

80 The average closing price for the 20 trading sessions ending March 4, 1986, namely, $31.40.

81 In its brief on exceptions, NFG has attempted to substitute National Fuel Gas Company's earned return in fiscal year 1985 (14.6%) for its witness's

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

OPINION NO. 83-1

CASE 28167 - NEW YORK STATE ELECTRIC & GAS CORPORATION - Electric Rates

CASE 28168 - NEW YORK STATE ELECTRIC & GAS CORPORATION - Street Lighting Rates

CASE 28169 - NEW YORK STATE ELECTRIC & GAS CORPORATION - Gas Rates

OPINION AND ORDER DETERMINING
REVENUE REQUIREMENT AND RATE DESIGN

Issued: January 11, 1983

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CONCURRENCE

DISSENT

Earnings Base-Capitalization Adjustment

In the early 1970's we adopted the FERC (then FPC) method of calculating the working capital allowance because we found the traditional lead/lag studies too cumbersome and the attendant expenses too high. At the same time, various other changes tended to increase the working capital and other components of the earnings base, and we responded by adopting the mechanism of the Earnings Base-Capitalization (EB-Cap) adjustment in order to determine the rate base for the rate year. The adjustment is accomplished by deducting from the projected rate base the excess of earnings base over capitalization in the historic test year.

In this case staff proposed to increase the EB-Cap adjustment, i.e., reduce projected rate base, by the amount of the projected increase in fuel inventory to be supported by accounts payable. Judge Robinson noted this was in accord with our standard practice and the company has acquiesced in the reduction. CPB, meanwhile, proposed a method of projecting the growth in the EB-Cap adjustment on the basis of the ratio of capitalization to conventionally calculated rate base in the historic test year, instead of simply projecting an excess earnings base in the same absolute amount. Judge Robinson rejected the proposal because he found that one cannot assume that the ratio obtained in the historic period is properly applicable to the rate year. CPB has not excepted, and Judge Robinson's rejection of the proposal was proper.

The remaining issue involves staff's proposal to refine the EB-Cap adjustment by isolating the company's "interest accrued" and projecting its growth (and the consequent growth in the EB-Cap adjustment) during the rate year. As explained by Judge Robinson,

> [i]nterest accrued refers to the company's liability for interest expense which has been incurred but not yet paid. Since customers pay rates calculated to cover interest expense on a continuous basis, while the interest itself is only paid semi-annually, the company can use this "interest-free loan" to finance rate base.1/

On this basis, staff proposed to reduce rate base beyond the adjustment called for by the historic EB-Cap adjustment.

The company countered by arguing, first, that the adjustment should be modified by excluding so much of it as relates to interest-bearing CWIP (IB-CWIP) excluded from rate base, inasmuch as the cost of IB-CWIP is not borne by the ratepayer. Staff rejoined that if this modification is made, it should itself be reduced to reflect the deferred tax benefits associated with the IB-CWIP, for ratepayers do not enjoy those benefits during the rate year, and they are thus available to the company as a source of non-investor supplied funds. Second, the company claimed the remainder of the adjustment should be reduced by 50%, to take account of the lag between the time service is rendered and payment is received. Staff acquiesced in this modification. Finally, the company offered an offsetting adjustment, intended to reflect the burden of unbilled revenues. Taken together, the company's modification would entirely eliminate staff's adjustment.

1/R.D., p. 222.

Judge Robinson agreed with the company on IB-CWIP and unbilled revenues, but he agreed with staff that the IB-CWIP modification should be limited on account of the associated taxes. On that basis, he recommends rate base reductions of $2,616,000 (electric) and $257,000 (gas). Staff and the company both except; the company's exception would wipe out the adjustment entirely (and, if carried to its logical conclusion, increase rate base); staff's exception would increase the adjustment to the original level of $7,750,000 (electric) and $500,000 (gas).

After discussing the complicated specifics of staff's proposal and the company's revisions Judge Robinson noted significant problems were created by attempting to "jerry-rig the historic year to fit the future."1/ He suggested that we might want to consider a rulemaking proceeding to address the issue. But we are convinced by the record in this case alone of the difficulty of projecting growth in elements of the EB-Cap differential. Moreover, consideration of such a refinement to the EB-Cap adjustment may encourage the proliferation of such adjustments, in which case the simplicity and convenience of the FERC working capital formula would give way to complexities greater than those posed by the old lead/lag studies that the formula was intended to obviate. Accordingly, we reject staff's adjustment as entailing an unwarranted attempt at refinement and as opening the door to other such refinements, which could either increase or reduce rate base but which would not be worth the effort dedicated to them. Given that resolution, we need not consider the company's offsets to staff's adjustment and staff's counter-offset.

1/R.D., p. 236.

STATE OF NEW YORK
PUBLIC SEVICE COMMISSION

COMMISSIONERS:

Charles A. Zielinski, Chairman
Edward P. Larkin
Carmel Carrington Marr
Harold A. Jerry, Jr., dissenting
Anne F. Mead
Richard S. Bower

CASE 27411 - ROCHESTER TELEPHONE CORPORATION - Telephone Rates

CASE 27681 - ROCHESTER TELEPHONE CORPORATION - Telephone Rates

OPINION NO. 80-38

OPINION AND ORDER DETERMINING REVENUE REQUIREMENT AND RATE DESIGN

(Issued December 1, 1980)

BY THE COMMISSION:

On Jan. [illegible] 3, 1980, Rochester Telephone Corporation ("RTC" or "the company") filed tariff revisions designed to increase intrastate revenues by $15.4 million, or 11.2%, over projected reve[illegible] for the year ending November 30, 1981.[1/] By various orders, we suspended the effective d[illegible] of the proposed revisions through December 2, 1980.

Nine days of hearings were conducted between February 26, 1980 and June 12, 1980. Administrative La[illegible] [illegible]udge J. [illegible]ichael Harrison presided at the first hearing, [illegible] afternoon and evening public statement session at which consumers, a repr[illegible]sentative of RTC's union employees, a RTC

1/In developing estimates of test year expenses, RTC employed as its historical base year the twelve-month period from October 1, 197[illegible] to September 30, 1979. The company then projected expenses for a partially forecasted fourteen-month "link year" (October 1, 1979 to November 30, 1980) and a fully forecasted test year (December 1, 1980 to November 30, 1981).

Accordingly, we shall grant the company's exception in part and reduce staff's proposed downward rate base adjustment by one-half.

Temporary Cash Investments

One analysis among the many undertaken in the process of determining a company's revenue requirement is the earnings base/capitalization adjustment. Our preferred procedure for computing the adjustment, which staff used in this case, is as follows:

1. The book values of nonutility assets paid for with investor-supplied capital are subtracted from base year capitalization.

2. The historic year earnings base (rate base plus interest-bearing construction work in progress) is compared to the adjusted capitalization. If the earnings base exceeds the capitalization, the excess is subtracted from base year rate base.

3. Projected additions to earnings base between the base year and the test year are added to the adjusted capitalization, reflecting an assumption that all plant additions are paid for with investor capital.

As this description suggests, the purpose of the earnings base/capitalization adjustment is to insure that a return is authorized on investor-supplied capital only. One of the reasons for the adjustment, as staff notes, is that the so-called FPC method of computing the cash working capital allowance included in rate base may provide an excessive allowance because it fails explicitly to take into account items such as accounts payable and taxes and interest collected in rates but not yet paid out. On the other hand, it is also not clear whether it measures all working capital requirements.[1]

All of the foregoing is background to the issue presented here of whether at least a portion of the company's temporary cash investments should be subtracted from the capitalization that is compared to the historic year earnings base in step 2 of the adjustment.

RTC, staff, and Judge Arkin each proposed different resolutions of the issue. Judge Arkin concluded that all temporary cash investments should be excluded from capitalization for purposes of the comparison with rate base, but also concluded that the adjustment should be calculated by comparing the <u>projected</u> earnings base and capitalization. Because the projected capitalization exceeded the earnings base by $5.658 million and the company forecasted test year temporary cash investments of $7.692 million, Judge Arkin reduced the rate base by the difference, $2.033 million. RTC had argued that no temporary cash investments should be excluded from capitalization; the amount it would include in earnings base, accordingly, is the $2.033 million removed by the Administrative Law Judge. Staff, on the other hand, recommended that all but $1.0 million of temporary cash investments be excluded from capitalization. The net result of this procedure, taking into account two smaller adjustments discussed below, would be to reduce the projected test year rate base by $12.5 million.

1/Cases 26848 and 26849, <u>Rochester Gas and Electric Corporation</u>, 16 NY PSC 294, 329 (1976).

Both RTC and staff except to Judge Arkin's decision. RTC's principal disagreement, however, is with staff.

RTC argues first that staff's entire approach to the earnings base/capitalization adjustment, which staff on exceptions urges us to adopt, is incorrect as a matter of policy because our policy statement on forecast test years[1] requires that the adjustment be calculated using forecasted data. We disagree. Our policy statement says that "major plant additions from the end of the historic period should be separately identified,"[2] and staff's method does nothing less than this. Staff's method also produces a projection of the test year capitalization devoted to financing utility plant, as our policy statement requires.[3] The company appears to object to the fact that this projection of additional capitalization precisely follows the rate base forecast, but the record shows that the company has not presented a better forecast. In fact, as staff points out, the company's projected capitalization includes an increase exceeding $8 million, which the company attributed, without substantiation, to "miscellaneous assets." The company argues that its use of this unsubstantiated addition to its projected book assets provides no basis for criticism of its approach because, it claims, that number merely balances historic year current assets with projected test year current assets determined by employing the FPC method for computing cash working capital. But this argument, not staff's criticism, misses the point. As we said earlier, the very purpose of the earnings base/capitalization adjustment is to avoid the

1/17 NY PSC 25-R (1977).

2/*Id.*, p. 27-R.

3/*Id.*

overstatement of the test year rate base that can frequently result when the FPC method is employed. To use an unsupported number to balance the results of that method with the capitalization, as the company recommends, would thus clearly defeat the purpose of the adjustment.

As the foregoing discussion suggests, the method used to compute the earnings base/capitalization adjustment has an important bearing on the specific issue presented here: whether, and to what extent, temporary cash investments should be included in rate base. While Judge Arkin concluded that no temporary cash investments should be recognized, his comparison of projected earnings base and capitalization figures suggested a rate base reduction of just over $2 million. Staff, on the other hand, recommended that $1 million in investments be included in rate base; but because it compared the company's historic earnings base and capitalization, it recommended a downward adjustment to rate base of about $12 million.

We shall adopt staff's method of computing the earnings base/capitalization adjustment. We have employed that method satisfactorily in several previous cases; it is not inconsistent with our policy statement on forecast test years; and we are not persuaded that the company's proposal offers a better projection of its investor-financed earnings base related to telephone utility operations. That much decided, we turn to the specific question of whether, and to what extent, temporary cash investments should be included in rate base.