

STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

CASE 89-G-078 - In the Matter of the Formulation of a Policy  
Regarding the Rate Treatment Afforded to  
Expansion of Gas Service into New Franchise  
Areas.

STATEMENT OF POLICY REGARDING RATE TREATMENT  
TO BE AFFORDED TO THE EXPANSION OF GAS  
SERVICE INTO NEW FRANCHISE AREAS

Issued and Effective: December 11, 1989

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(Issued and Effective December 11, 1989)

INTRODUCTION

By notice issued April 28, 1989, we invited comments on a proposed policy regarding rate treatment to be afforded to the expansion of gas service into new franchise areas. The proposed policy entailed the following concepts:

- A. Economic impacts of new franchise projects would be evaluated on the basis of a five-year development period.
- B. During the development period, one half of the investment, plus related costs (e.g., depreciation), would be excluded from rate-making consideration.

C. All revenues, expenses, and rate base items, except as provided in B above, would be afforded normal rate treatment as and when rates were established after approval of the expansion.

D. During the five-year development period, gas utilities would be authorized to apply a surcharge on sales to customers receiving gas service in the new franchise area, to recover all or a portion of the carrying costs associated with the costs not afforded rate treatment. The surcharge might be adjusted during the development period, but would not exceed the level initially reported to customers, and would be terminated at the end of five years from the first availability of gas service in the new franchise area. All prospective customers would be advised of the amount of any surcharge prior to their taking service.

E. If a utility proceeded with an expansion project on the foregoing terms, it could be presumed that the project had a reasonable expectation of success; and after the five-year development period, the expansion surcharges would end, the project would be included in normal rate-setting procedures, and the one-half of rate base that had been excluded from normal rate treatment during the five-year development period would be allowed into rate base after that time,

net of normal depreciation accruals for the five years. Parties would not be precluded, however, from challenging the project's full inclusion in later rate cases.

Comments were received from seven utilities.<sup>1</sup> One non-utility party, Ferro Corporation (Ferro), which operates an industrial plant in Dresden, New York, submitted a letter dated July 11, 1989 endorsing the proposed policy and encouraging the granting of a gas franchise for Dresden.

The comments raise a variety of issues pertaining to the proposed policy; they are discussed in order.

#### NEED FOR A POLICY

Ferro states that the proposed extension of the development period to five years and implementation of a reasonable surcharge are encouraging moves that could help bring economic opportunity and growth to areas that might remain forever depressed if a full return on investment in the initial period were the criterion. Ferro believes that requiring the utility to absorb some development costs is fair consideration for expansion that will bring shareholders profits in the future.

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<sup>1</sup> The Brooklyn Union Gas Company (Brooklyn Union), Central Hudson Gas & Electric Corporation (Central Hudson), National Fuel Gas Distribution Corporation (NFG), New York State Electric & Gas Corporation (NYSEG), Niagara Mohawk Power Corporation (Niagara Mohawk), Rochester Gas and Electric Corporation (RG&E), and St. Lawrence Gas (St. Lawrence).

The comments of the seven utilities are quite diverse. They range from NYSEG's assessment that guidelines are necessary so that utilities can evaluate their risks and make expansion decisions, to Niagara Mohawk's doubt that a policy is needed, given the Commission's existing certification, ratemaking, and investigative powers.

Brooklyn Union, NFG, Niagara Mohawk, and RG&E believe that Commission policies should encourage the expansion of gas service, the first two citing goals expressed in the draft New York State Energy Plan. Brooklyn Union points to the State's additional energy policy advocating displacement of oil consumption. Central Hudson says that expansion of service cannot be achieved without some cross-subsidization between classes and between existing and new customers, and St. Lawrence believes some subsidization of new service may be acceptable since expanded availability of gas service is beneficial to all. Brooklyn Union, NFG and Niagara Mohawk oppose adoption of the proposed policy, claiming it would deny utilities a reasonable opportunity to earn authorized rates of return in new franchises, discourage such investments, and fail to offer potential rewards to counter-balance the risks of shortfalls. NYSEG endorses the idea of guidelines, but questions, as overly optimistic, the policy's expectation that a typical project would yield a full return within five years. NYSEG asks that any rate base disallowances be based on flexible assessments of reasonable achievement, and that alternative treatment be permitted for new projects when circumstances call for it.

Central Hudson and St. Lawrence analyze the proposed policy from unique perspectives. Central Hudson sees the franchise problem as arising from the Commission's reviews of competing applications.<sup>1</sup> Much of its submission is based on a concept that the competitive element fosters a "special economic dynamic," and that the questionable economics of projects are attributable principally to exaggerated claims by parties to gain the competitive edge. But those points go to the evaluation of the merits of competing applications, and Central Hudson's proposed supplement to Commission regulations to require evidence on "economic viability" and "gas plant planning" would also pertain more to comparative analyses of competing applications than determinations as to whether any certificate should be issued at all.

St. Lawrence offers comments based on its start-up experience from 1962 through the 1970s. It urges deregulation of rates for newly franchised areas for extended periods such as 25 years, and recognition of "going value" whereby a utility could capitalize early-year losses for recovery in later years as the utility and its service area are better established. The former proposal would have the Commission abdicate its ratemaking responsibility; the latter was proposed by St. Lawrence in previous

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<sup>1</sup> Five of Central Hudson's certificate cases have involved applications by competing utilities.

rate cases and rejected as retroactive ratemaking.<sup>1</sup>

The diversity of the comments suggests a policy statement would be beneficial. The parties that believe the existing system is satisfactory have not answered the stated concern that no standards exist, and the parties that endorse establishment of a policy aptly point out that the utilities and entities seeking expansions into new franchise areas would be better able to assess conditions and plan accordingly. Adoption of a policy, rather than a specific regulation, will answer the concerns of those utilities that argue for evaluation of individual applications on their own merits; a policy will offer guidelines but permit consideration of other factors upon adequate showing by an applicant.

**FIVE-YEAR DEVELOPMENT PERIOD**

The utilities agree that franchise proposals should be reviewed on terms longer than the three years for which projections are required by Part 21 of our rules. Brooklyn Union asserts that investments in facilities that will provide service for fifty years cannot be economically evaluated on the basis of a short-term analysis. St. Lawrence points out that it did not realize a profit during its first ten years of operation. The other companies believe evaluation on a five-year basis is reasonable,

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<sup>1</sup> Case 26111, St. Lawrence Gas Company, Inc., Gas Rates, Opinion No. 72-8 (issued March 29, 1972), mimeo p. 10. Case 26678, St. Lawrence Gas Company, Inc., Gas Rates, Opinion 75-8 (issued April 17, 1975), mimeo p. 2.



though RG&E would additionally require a showing of economic feasibility based on a 20-year net present value analysis of cash flows resulting from the project.

A five-year development period will be adopted. It reasonably balances recognition that attracting customers in new franchise areas generally requires several years, and the difficulty of reliably projecting the long-term economics of new gas service. RG&E's proposal for a required net present value analysis of 20-year cash flows would similarly be of limited benefit because of the weakness of long-term forecasts.

#### OPERATION OF THE POLICY

The proposed policy would exclude one-half of the investment, plus related costs, from rate consideration.

#### Comments

Niagara Mohawk argues that excluding one-half of capital investments for five years would penalize a utility interested in developing new territory. It maintains that existing processes in certificate and rate cases permit adequate review of expansion projects and costs, but it offers no guidance on how an application should be judged other than considering "...the propriety of the business decision by the utility and the economic feasibility of the project."<sup>1</sup> Niagara Mohawk goes on to ask whether the one-half

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<sup>1</sup> Comments by Niagara Mohawk Power Corporation, p. 2.

exclusion should continue for five years even where actual experience is better than was projected.

Brooklyn Union claims the proposal does not encompass incentive ratemaking, and says that if one-half of the investment is excluded from rate determinations, one-half of the related revenues and expenses should be afforded similar treatment. Central Hudson asserts a better alternative to one-half exclusion would be to exclude the average percentage of the investment that makes the economics unsatisfactory over the five-year period,<sup>1</sup> while NYSEG suggests that any exclusion be decreased as increasing revenues justify higher investment levels. RG&E recommends that an exclusion apply only if, and to the extent that, the projected rate of return for the fifth year is less than 75% of the system average return.

NFG suggests recognition of the five-year growth for a new service area be combined with an incentive to the utility, through progressive imputation of the revenue required for a full return on a pro-rata basis over five years (year 1, 20%; year 2, 40%... year 5, 100%). The utility would be at risk for any shortfall and would keep any benefit above the imputed level.

As for surcharges, the proposed policy would allow utilities to impose a surcharge on customers in the new franchise

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<sup>1</sup> Central Hudson points out that with this approach, the excluded amount could be more or less than the proposed one-half.

area for up to five years, and up to a maximum level that would recover the carrying costs associated with the excluded investment.

Brooklyn Union and Niagara Mohawk claim the surcharge might be counter-productive, damaging competitive positions and discouraging the addition of customers at a time when utilities must be most competitive to develop a new territory. In contrast, NFG, NYSEG, RG&E, and (to a lesser extent) Central Hudson, generally support the surcharge concept, provided it is optional and flexible, but ask for various clarifications or refinements.

Central Hudson questions how a surcharge would operate as to a franchise area vis-a-vis a discrete project within an area that leads to a municipal-wide certification. Specifically, it believes that a surcharge should apply uniformly to the total franchise area, not just the initial project, since the service to the discrete portion of a municipality aids the economic growth of other portions where gas service may come later, and the plant investment is commonly made to serve a project with expectation of sales potential beyond the immediate project area. Conversely, NYSEG asks that utilities be authorized to surcharge all new customers (i.e. sales and transportation), but have flexibility to vary surcharges to different customer classes in response to price sensitivity or competitive conditions. NYSEG also suggests that surcharges be spread over ten years (though recovering the shortfalls for only the first five years), to avoid creating large disincentives for potential customers.

Central Hudson also questions the extent to which a utility would be allowed to fix a surcharge "...at whatever level it believes would maximize the economics of the expansion considering market conditions..."<sup>1</sup> and the time when the maximum level of surcharge would be quoted to potential customers.

NFG asks that the policy allow municipalities to contribute to capital costs or provide other guarantees for the investment if municipal leaders wish to promote gas as an economic development tool.

Only in rare instances will a new franchise achieve a full return over the five-year development period, in which case no risk would be associated with the project. It is more likely that a project will earn little, if any, return in the early years and gradually improve as customers are attached. In that case, there would be a shortfall to be allocated among the utility, existing ratepayers, and the new franchise customers.

If a new franchise area is expected to produce a full return by the end of the development period (i.e., the fifth year), it is reasonable to expect that the expansion will be beneficial to existing ratepayers in the long run. The long-term benefit can be recognized, and the development costs assigned to current ratepayers, through normal rate treatment during the development

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<sup>1</sup> Notice of Proposal to Issue a Statement Concerning New Gas Franchise Areas. Request for Comments, issued April 28, 1989, p. 6.

period. The investment, revenues, and costs will be reflected in any rate proceedings occurring during the development period, and overall revenue requirements will include shortfalls for the new franchise. No exclusions, imputations or surcharges will apply in this situation.

If, on the other hand, a new franchise area is not projected to earn a full return by the fifth year of the development period, the risk of failure will have to be assigned to the utility and customers in the new area. This can be accomplished through a ratemaking exclusion (to assign the risk to the utility) and the availability of a new customer surcharge (to allow the utility to transfer some portion of the risk to, and recover some of the excluded costs from, the new customers).

#### Discussion and Conclusion

In light of the comments received, our policy will expose the utility to risk of any shortfall from a full allowed return, and limit the upside opportunity to the level that would achieve a full return. The mechanism for doing so will be easy to administer.

The average level of additional annual revenues which the project would require over the five-year development period in order to realize a target return, considering all of the related costs and expenses, will be determined in each franchise application and imputed in rate proceedings occurring during the development period. The imputation will remain constant during the five-year period, and parties in rate proceedings will have but one identified adjustment (the revenue deficiency) to deal with.

The utility will be allowed to levy a surcharge on all sales made in the new franchise area during the five-year development period, at a level no greater than that needed to recover the imputed five-year revenue shortfall. The maximum surcharge will be calculated on the basis of an equal unit assessment to all sales and transportation volumes, and the imposition of surcharges up to that level will be at the discretion of the utility. Because the circumstances of each expansion are unique, and because market conditions change over time, the utility may offer reductions to individual classes. For example, smaller or no surcharges may be warranted for more competitive classes, if the attachment of those customers would benefit the system but be precluded unless surcharges were reduced. The reduction of a surcharge to a particular class, however, will be at the utility's risk and may not result in a greater than average surcharge to other classes. Further, during the five-year period the utility may at any time reduce or eliminate surcharges entirely if it believes they are no longer needed to achieve a full return or are counter-productive to development of the area. (Since surcharges could be applied to further expansions in a given franchise area, the level of unit surcharges necessary to make a utility whole may decrease as sales increase.) Finally, contributions from municipalities or individual customers will be allowed as offsets to the need of surcharges.

The utility will, in effect, be held to the projections adopted in the franchise proceeding, and both the surcharge and the

imputation will be established accordingly. This will produce a self-policing situation, since a low projection of the economics of an expansion will result in a high imputation in rate cases while a high projection will limit the level of surcharge allowed.

RELATED QUESTIONS

In addition to comments on the proposed policy, responses were invited to the following related questions:

1. If an expansion is accomplished by a gas utility in accordance with this policy, should it be deemed to be prudent? If so, under what conditions or standards should a challenge to prudence be allowed?
2. Should alternative treatment be afforded for expansions where the economic impact is minimal due to the small scale of a project or the expected achievement of satisfactory rates of return very early in the development period?

With regard to the first question, Central Hudson, NFG, NYSEG, and RG&E claim certification under Section 68 of the Public Service Law should be determinative of the prudence of the project and the investment. Expansions completed in accordance with the certificate should not be subject to later reviews, except for matters such as project mismanagement or excessive costs relative to originally proposed plans and service.

The companies make a reasonable argument that if standards are established in the form of guidelines, applications which are approved as conforming to those guidelines should reduce the risk of future findings of imprudence as to the decision to expand.

Therefore, conforming expansions will bear a rebuttable presumption of prudence, but utilities will remain answerable for mismanagement; actions that lead to excessive costs; or expansions shown to have been based on misrepresentations or on data or forecasts that prudent managers should have known to be inaccurate, outdated, or otherwise flawed. As in all prudence examinations, the judgment will be based not on hindsight, but on how a prudent person would have acted in the circumstances.

As for the second question, Central Hudson suggests exemption for projects where the full return is projected to be achieved by the third year; NYSEG argues likewise if there will be a "...likelihood of obtaining a reasonable return in the early years...",<sup>1</sup> and RG&E advocates exemption if the fifth year return exceeds 75% of the allowed return. The policy being adopted grants normal rate treatment for projects expected to earn a full return by the fifth year (supra, p. 10).

NFG would exempt projects with relatively small investment in relation to existing plant. Central Hudson and NYSEG define "small investment" as less than 2.5% and 1.5%, respectively, of existing plant. NYSEG offers a further aggregate cap of 2% for multiple projects in any year.

Establishment of a fixed threshold for exemption, regardless of the expected economics, is not reasonable. The

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<sup>1</sup> Comments of New York State Electric & Gas Corporation, p. 3.



utilities suggest a small project would have little impact on existing customers, even if it did not show economic feasibility. But the impact on existing customers is only one factor to be considered, and the standards should not encourage utilities to proceed with unreasonable expansions. Without exemptions, large and small projects will each be evaluated on the basis of relative rewards and risks, and the economics of a project are not necessarily correlated with its size. The policy will focus on the economics of the project, without regard to the scope or size of expansions. Finally, as noted, the policy statement will serve as a guideline for review, but utilities will be free to request waiver of the policy if individual circumstances so warrant.

#### GRANDFATHERING OF PENDING APPLICATIONS

Niagara Mohawk asks that if a policy is adopted, any franchise applications that are made before the new policy is formally adopted be exempt from treatment under the new policy. But grandfathering is not necessary here since the policy only establishes guidelines for evaluation and such guidelines could be employed to evaluate existing applications even if a formal policy were not adopted.

#### CONCLUSION

After review of the proposal and the comments received, we adopt the following policy as to the rate treatment to be afforded to the expansion of gas service into new franchise areas.

1. Economic impacts of new franchise proposals will be evaluated on the basis of a five-year development period.

2. If a new franchise proposal is projected to earn a rate of return by the fifth year of development that is at least equal to the allowed rate of return for the utility applicant, all investment, revenues and expenses will be afforded normal rate treatment.
3. If it is determined that a new franchise proposal is projected to earn less than a full rate of return by the fifth year of development, revenue levels established in rate proceedings during the five-year development period will include imputations equal to the projected average annual revenue deficiency for the new franchise area.
  - a. The revenue deficiency shall be the five-year average annual deficiency, established at the time of certification on the basis of the projected estimates of all revenues, costs and investments.
  - b. The amount of imputed annual deficiency will not be changed during the five-year development period.
  - c. Contributions of customers or municipalities toward capital costs will be allowed and recognized to reduce revenue deficiencies.
4. If a revenue deficiency is found, utilities will be authorized to assess surcharges on all sales in the new franchise area for a period up to five years from the commencement of gas service.

- a. A maximum surcharge will be calculated on the basis of the aggregate five-year revenue deficiency divided by total estimated sales for the first five years.
  - b. Separate surcharge levels may be established for individual customer service classifications and surcharges may be adjusted during the development period, but the unit surcharge for any class may not be greater than the overall maximum level.
  - c. Subject to the maximum level, surcharge rates may be modified or eliminated at any time during the development period at the discretion of the utility.
  - d. Potential customers in the new franchise area shall be advised of the maximum and expected levels of unit surcharge prior to their taking service. If final surcharge levels differ from those previously described in customer surveys, potential customers shall be notified of the changes prior to their applying for service.
  - e. Surcharge revenues will be excluded from rate case determinations.
  - f. Surcharges for all customers in the new franchise area shall terminate five years from the commencement of gas service in the new franchise area.
5. Extensions of gas service in new franchise areas during the development period, beyond the project for which the certificate has granted, shall also be subject to main and

service line extension rules as contained in 16 NYCRR, Part 230, and utility tariffs.

6. New franchise expansions accomplished in accordance with this policy shall bear a rebuttable presumption of prudence, but utilities will remain subject to reviews for prudence of project management or cost levels, or expansions shown to have been based on misrepresentations or on data or forecasts that prudent managers should have known to be inaccurate, outdated, or otherwise flawed. Subject to such prudence challenges, normal ratemaking procedures shall apply to all revenues, costs and investments after five years.

7. Alternative standards or measurement of the economic feasibility of new franchise expansions may be considered by the Commission upon adequate showing by utilities.

By the Commission,

John J. Kelliher  
Secretary