National Fuel

October 18, 2007

VIA HAND DELIVERY

Hon. Jaclyn Brilling
Secretary
Public Service Commission
Three Empire State Plaza
Albany, New York 12223-1350

Re: Case 07-G-0141 -- Proceeding on Motion of the Commission as to the rates, charges, rules and regulations of NATIONAL FUEL GAS DISTRIBUTION CORPORATION for gas service.

Dear Secretary Brilling:

Enclosed please find an original and twenty-five (25) copies of the Exceptions of National Fuel Gas Distribution Corporation in Case No. 07-G-0141.

Thank you for your attention to this matter.

Respectfully submitted,

Michael W. Reville

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TABLE OF CONTENTS

Case 07-G-0141 – Proceeding on Motion of the Commission as to the Rates, Charges Rules and Regulations of NATIONAL FUEL GAS DISTRIBUTION CORPORATION for Gas Service.	:	Before the Commission

EXCEPTIONS OF
NATIONAL FUEL GAS DISTRIBUTION CORPORATION

I. INTRODUCTION

On January 29, 2007, National Fuel Gas Distribution Corporation ("Distribution" or "the Company") filed amendments to its tariff schedule for changes to its rates, charges, rules and regulations for gas service to become effective on February 28, 2007. As initially filed, the revisions would have produced an increase to base rates of $51,981,000 or 6.4% in annual gas revenue for the Rate Year ending December 31, 2008. By a one-commissioner order dated February 20, 2007, Commissioner Buley suspended the effectiveness of the new rates until June 27, 2007. That order was confirmed by the Commission on February 27, 2007.

On March 14, 2007, Secretary Brilling issued a Notice of Initial Conference before presiding Administrative Law Judge William Bouteiller ("Judge Bouteiller" or "the ALJ") to be held on April 17, 2007. On April 18, 2007, Judge Bouteiller issued his Ruling Establishing Case Schedule.

On June 20, 2007, the Commission further suspended the proposed rates through December 27, 2007.

Public statement hearings were held before Judge Bouteiller in Buffalo and Niagara Falls on July 11, 2007.

Evidentiary hearings were held on July 24 and 25 in Albany before Judge Bouteiller. Witnesses testified on behalf of the Company, the Staff of the Department of Public Service ("Staff") and Consumer Protection Board ("CPB"), Direct Energy and the Independent Oil and Gas Association of New York. In addition, New York State Energy Research Development Authority, Multiple Intervenors ("MI"), and

Constellation New Energy-Gas Division, LLC participated in various elements of the proceeding. The record consists of 1,727 pages of transcript and 67 exhibits.

During the course of the proceedings, Staff filed a Motion asking to have the Company's Conservation Incentive Program ("CIP") severed from the previously established procedural schedule and addressed on an expedited basis. Judge Bouteiller granted Staff's motion on August 8, 2007 and on September 20, 2007, the Commission issued an order approving CIP with modifications.[1] The September 20, 2007 order did not, however, address CIP in its entirety, and expressly reserved some issues for Judge Bouteiller's consideration under the existing rate case schedule.

On September 28, 2007, the Secretary issued Judge Bouteiller's Recommended Decision ("RD") finding that Distribution's rates should be increased by $2.5 million, among other things. Although Judge Bouteiller did a thorough job of identifying and analyzing the issues in controversy, the Company does not agree with every finding in the RD. In the Company's view, the evidence supports a revenue requirement as set forth in the Company's initial brief. The Company's exceptions follow.[2]

II. GENERAL OVERVIEW

While it is true that each element of this filing can be decided in a vacuum, the Company asks that the Commission view it in a broader context. Certainly, the Commission's mandate is too keep rates as low as reasonably possible. But low rates are not an end in themselves.

In his State of the State message Governor Spitzer noted that "we must get back to our roots and stake out a bold vision for infrastructure investment." Distribution's system provides valuable access to natural gas energy supplies for Western New York and provides significant benefits to the region. Tr. 1639. In order to keep this system in good repair, investors must provide approximately $40 million of new investment each year. Exh. 64, RLT-6 Sch. 2, Sh. 3. Dollars, however, flow where the best return is

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1 Distribution is currently in the process of implementing CIP for the winter period.

2 To aid readability and assist referencing, this brief is organized to match the order of issues in the RD.

provided. The RD counsels setting rates on a rate of return on equity ("ROE") of just 9.4%. This is almost 110 basis points lower than the average cost of equity of 10.48% allowed by utility regulatory commissions around the country (Tr. 216) and would place the Company at a competitive disadvantage in the race to raise funds for infrastructure improvements. Keeping rates low at the expense of putting the Company at a competitive disadvantage for funds vis-à-vis other utilities is not good policy.

Furthermore, keeping rates low is not the sole province of the Commission. It is a shared endeavor between the regulator and regulated companies. One of the most critical factors in controlling rate increases is cost control. In this context, the Commission must not lose sight of how efficient a provider of utility services this Company has been and how its efforts have counteracted a very trying environment.

Distribution operates in an environment of virtually no growth and declining throughput. Virtually all of the population within proximity of the Company's system are customers and, so, opportunities for growth are non-existent. Moreover, throughput falls almost every year; usage per residential customer, for example, has declined from levels of 170 Mcf per year in the 1970s to just over 100 Mcf per year today. On the industrial front, the Commission is well aware of the drastic declines in manufacturing activity that have occurred in Western New York. An environment of declining usage, coupled with the need to make infrastructure investments every year, is a prescription for ever increasing rates. And yet, the Company's ability to contain rate increases to below the rate of inflation has been remarkable.

For example, if one were to apply the rate of inflation to the total September 1996 net revenue of $280,912,000, the result would be $61,788,000 higher than the Company's actual September 2006 net revenue of $285,965,000. Tr. 1632. If Distribution's cost of doing business had simply kept pace with inflation, it would have required a rate increase of over $78 million just to stay even.

Another example of just how efficient the Company has been at controlling costs also can be seen by comparing Operating and Maintenance ("O&M") expenses at the end of Fiscal 1996 with its O&M

expenses today. Fiscal 2006 O&M costs of $140,253,000 are $9,071,000 below cost levels in Fiscal 1996. Tr. 1633. Moreover, if the $12,000,000 of expenses that relate to the Company's proposed Conservation Incentive Program are disregarded, the estimated O&M costs for the Rate Year are still below the 1996 O&M levels – 12 years later. Tr. 1634. If one merely applied inflation to the 1996 O&M levels, the Company's Rate Year O&M expense would be almost $34 million higher than it is. Id.

The cost containment results that Distribution has achieved have not been easy. Distribution's employees have constantly been asked to do more with less. In September 1996, the Company's New York utility workforce stood at 1,671. At the time this case was filed, it had been reduced to just 1,107 employees. Tr. 1634. Moreover, the RD has adopted Staff's trend analysis that will reduce the employee count by an additional 54 positions. RD p. 14. This adjustment – to which the Company has not excepted – equates to additional productivity adjustment of six percent. Very few companies can match this productivity achievement. Nor can productivity of this magnitude continue indefinitely.

It is with these considerations in mind that the Company presents its brief on exceptions. Only when the larger picture is considered can the diverse, individual components of this case be determined within a consistent and cogent theme of fairness to the Company's customers and recognition of the very significant role the Company has played in keeping rates as low as possible under very trying circumstances.

III. COST OF CAPITAL

A. Capital Structure

The Company's filing is based on a hypothetical equity ratio of 51.5%. This is less than the 53.9% consolidated equity ratio of its corporate parent, National Fuel Gas Company ("National"). Company witness Hanley developed this hypothetical equity ratio based on the average equity ratio of a company rated "A-" with a business profile of 4. The RD rejected the Company's proposal and imputed an equity ratio of 47.25% based on a split bond rating of "BBB+/A-" and a business profile of 4. RD p. 6. Although the use of a business profile of 4 is conservatively appropriate, the use of a split bond rating is not. When the bond rating is corrected, the Company's proposed equity ratio is validated.

Mr. Hanley developed his hypothetical capital structure by determining the equity ratio of his proxy group and then adjusting it for the higher risk of Distribution vis-à-vis that group. Id. He found that the average bond rating of his proxy groups was "A3" by Moodys and "A" and "A+" by Standard & Poor's ("S&P's"). Id. Mr. Hanley recognized, on the other hand that, on a stand-alone basis, Distribution would likely have a bond rating of "A-." Tr. 155. Based on his observation of a bond rating of "A-" and a business profile of 5, using S&P's rating criteria, Mr. Hanley observed that Distribution would require an equity ratio in the range of 50-58%. Tr. 155. Even a less risky business profile of 4 would indicate the need for an equity ratio in the range of 48-55% for a company with an "A- bond rating. Id. An imputed, hypothetical equity ratio of 51.5%, which is in the midpoint of the range for a less risky business profile of "4," is conservative (Id.) and discredits the approach adopted in the RD.

The 47.25% equity ratio adopted by the RD is simply the midpoint of the range of 43% to 51% for a company with a split bond rating of "BBB+/A-" and a business rating of 4.[3] There is no basis for using a split bond rating of "BBB+/A-" for Distribution.

The average bond rating of Mr. Hanley's proxy groups is "A" or better. Moreover, 11 of Staff's 13 companies had subsidiaries that had separately rated debt. Their average bond rating is "A-" and "A3". Tr. 206. Furthermore, if separately rated, Distribution would have a higher bond rating than National does because it is less risky. Tr. 155. Therefore, Distribution's bond rating would be "A-" and not the split rating of "BBB+/A-".

The criteria to apply to Distribution for purposes of estimating an appropriate hypothetical capital structure cannot be lower than an "A-" bond rating and a business profile of 4. That combination produces a range of equity ratios of 48% to 55%, within which Mr. Hanley's imputed equity ratio of 51.50% for Distribution lies comfortably.

Furthermore, the Recommended Decision in the Generic Finance case explicitly found that the Commission should provide revenue sufficient to support an "A" bond rating. Case 91-M-0509,

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[3] The RD found there was no basis for choosing either the high or low end of that range. RD p. 6.

Recommended Decision, issued July 19, 1994 at 88 ("Generic Finance RD"). Staff conceded that the Commission found that an "A" bond rating is desirable. Staff IB p. 5, fn 2. The midpoint of S&P's equity ratios for companies rated A with a business profile of 4 is 51.50%. Tr. 155. The RD's imputed equity ratio of just 47.25% which is based explicitly on a split rating of "BBB+/A-" and a business profile of 4 is insufficient to support an "A" bond rating.

Finally, the RD rejected the use of the parent, National's, equity ratio, based, in part, on its finding that the Company's witness considered the parent's equity ratio to be "inappropriate." RD p. 4-5. Company witness Hanley did not find National's equity ratio to be "inappropriate." He testified that, although the capital structures of the parent "might be appropriate for use in determining Distribution's cost of capital," he would prefer to employ a hypothetical capital structure composed of 48.50% debt and 51.50% equity. Mr. Hanley preferred the use of an imputed equity ratio given the potential for volatility in the parent's capital structure and the fact that the hypothetical structure relates more directly to LDCs such as Distribution and thus argues for its use over the consolidated capital structure. Tr. 154.

The Commission has made clear its preference that the capital structure to be used for ratemaking purposes is the capital structure of the parent, in this case National:

> To begin, the established regulatory practice in New York in fully litigated rate proceedings, like this one, is to use the consolidated capital structure of the holding parent company for ratemaking purposes. This practice has typically been applied to utility holding company structures in other regulated industries.

Case 05-E-1222, New York State Electric & Gas Corp., Order Adopting Recommended Decision With Modifications, Aug. 23, 2006, p. 87. Here, the projected Rate Year equity ratio for the parent is 53.9%. Tr. 153. If the Company's hypothetical equity ratio methodology is to be rejected, the 53.9% equity ratio of the parent should be employed for ratemaking purposes as has been done in the past. The 53.9% equity ratio of the parent would support an "A" bond rating for Distribution.

B. Cost of Equity

1. The Generic Finance Recommended Decision Recognized That Change Was Necessary.

Using a variant of the method recommended by the co-facilitators in the decade old Generic Finance case, the RD concludes that the Company's cost of equity is 9.4%. RD p. 11. While Distribution appreciates the effort made in the RD to reconcile and try to harmonize the Commission's historical reliance on the discounted cash flow ("DCF") methodology with the demonstrated infirmities of that method, the fact remains that reliance on unreliable results can only produce an unreliable answer. Further, as the RD realizes, a rigid adherence to the methods prescribed by the Generic Finance case co-facilitators more than a decade ago cannot be reconciled with changes that have occurred since that time. When the flaws in the Generic Finance methodology and recognized and corrected, as they must be – and as the Generic Finance co-facilitators expected they would be - a more reasonable cost of equity in the range of 10% become apparent.

Before even addressing the obvious weaknesses in the currently applied Generic Finance method, the Company would be remiss if it did not register a strong dissent to any claim that the Generic Finance case stands as "precedent" to which the Commission is bound in any manner. The RD criticizes the Company for presenting a witness that presented the cost of equity from four different perspectives – the DCF, the Capital Asset Pricing Model ("CAPM"), the Risk Premium ("RP") model and the Comparable Earnings ("CE") approach, in light of the fact that the Commission has "ruled out" the RP and CE approaches in favor of a Generic Finance methodology. RD p. 7. With all due respect, the Company presents these methods because it is clear that investors rely on all of them.[4] Indeed, as will be explained, the RD, itself, adopted a variant of the CE method.

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[4] Company witness Hanley employed an analysis that investigated the cost of equity as determined by an Efficient Market Hypothesis ("EMH"). An efficient market is one in which security prices reflect all information relevant to investors. Tr. 158. Staff agreed that the goal in this case is to determine the cost rate for the Company's common equity as determined by investors. Exh. 23, Dist-32, p. 1. Under the EMH, investors factor in all relevant information. Mr. Hanley, accordingly, employed four different analyses that investors commonly used to determine equity cost rates. They are: the DCF method; the CAPM; the RP method and the CE model. Staff agrees that the "most common" methods employed are the DCF, CAPM, RP and CE models. Exh. 23, Dist-32, p. 2. Therefore, the unrefuted evidence in this

Moreover, the Generic Finance case cannot stand as any binding "precedent." The fact is that, under the collaborative umbrella of Case 91-M-0509, representatives of the gas and electric companies in the state, Staff, the Public Utility Law Project ("PULP"), rate of return experts and other parties developed what was termed a "Consensus Document."[5] In this document, the signatories proposed that the cost of equity be determined using an equal weighting of the DCF, the CAPM and the CE method. See Case 91-M-0509, Recommended Decision of Co-Facilitators, issued July 19, 1994, p. 11. The cost of equity would be calculated twice a year based on proxy groups having an "A" bond rating. Id. The results would be adjusted for deviations from the "A" bond rating. Electric companies would have their costs determined by electric proxy groups and gas companies by gas proxy groups. See Id. at 27-28. Furthermore, in a financial integrity document signed by the companies, Staff, CPB, PULP, MI and IPPNY, the parties concluded that an "A" bond rating remains an appropriate target. Id. at 13.

At least two other matters should be borne in mind about the Generic Finance case. There were never any hearings. All work was done through meetings and collaboration. The Consensus Document was submitted to the Co-Facilitators as a contested settlement. If the document was not adopted in its entirety, the signatories were not to be bound by it. The resulting decision by the Co-Facilitators in the Generic Finance Case rejected the Consensus Document. Based on no evidence and no hearings, the Co-Facilitators rejected the Consensus Document and determined that the cost of equity should be determined using proxy group DCF and CAPM analyses but excluding a comparable earnings analysis. Furthermore the Co-Facilitators determined that the DCF should, at least initially, be weighted 2/3 to a 1/3 weighting of the CAPM – instead of the equal weighting counseled by the Consensus Document. Id. at 60.

Thus, given its rather clear procedural and evidentiary infirmities the so-called "generic finance" methodology resembles an administrative Potemkin Village. As such, the Co-Facilitators' Generic

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case supports reliance on all four methods and supports the reasonableness of the Company's requested ROE of 11.65%.

[5] There were also separate collaborative meetings held and documents produced for the telephone and water industries.

Finance decision should never have risen to the status it has apparently attained in the eyes of some. Certainly, the Company does not acquiesce to either its legality or validity and reserves all rights to contest it. On the other hand, the Company is not blind to the reality that the Commission has claimed to have used this methodology over the intervening years to determine the cost of equity for the utilities it regulates, recently endorsing this method in the above-referenced NYSEG opinion.[6] Therefore, to reduce controversy, the remainder of the Company's discussion of its cost of equity will be made in the context of the Generic Finance RD. In this context, the Company will show, that, while the RD here attempted to correct for the more glaring problems of the co-facilitators' method, by continuing to hew to a dogmatic reliance on the DCF results, the RD continues seriously to understate the Company's cost of equity.

Further, the Generic Finance RD was not meant to be the final word on cost of equity determinations. The RD in the instant case recognized this. It just did not go far enough if taking into account the degree of the unreliability of the DCF.

2. The DCF Is Inherently Unreliable and Should Be A Subsidiary Method to the CAPM.

The RD took a major leap forward in correcting the infirmities that have developed in the generic finance method, when it rejected giving the DCF method twice the weight of the CAPM in determining the cost of equity. R.D. p. 10. In fact, the RD appears open to giving the DCF even less than equal weight when it states "at most the DCF should receive equal weight with the CAPM." Id. The DCF should not be given equal weight with the CAPM. As will be demonstrated in further detail below, over weighting the DCF simply adds imprecision and controversy to the final ROE result because the DCF results of the parties are so different while their CAPM results are so similar. If the DCF is to be used at all, the truly unrealistic results that it produces – high and low – must be removed from the analysis before it is used to determine a company's cost of equity.

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[6] The Generic Finance method does not acquire some form of heightened evidentiary validity solely by virtue of its repeated use. As further explained infra, each analysis must stand on its own merits (See §IV.B.).

First, because there were no hearings in the Generic Finance case, its conclusion that the DCF is entitled to twice the weight of the CAPM lacks evidentiary support. Furthermore, there is no evidence in this record that supports giving twice, or even equal, weight to the DCF compared to the CAPM.[7] The DCF exhibits a clear bias to understate the cost of equity when stocks are trading above book value, as they are today. Staff conceded that the DCF understates the cost of equity when stocks are selling above book value. Tr. 1126. And, Staff further conceded that, unlike the DCF, the CAPM does not suffer from this (or any other) bias. Tr. 1126. When the Generic Finance RD was issued on July 19, 1994, the average market to book ratio of Staff's proxy group was 135.6%. Tr. 229. In 2006, the market to book ratio of that group had grown to 179.8%. Id. Thus, if anything, the understatement of the cost of equity that the DCF produces when stocks are selling above book value has grown more extreme since the issuance of the Generic Finance RD. Given that the DCF suffers from an acknowledged infirmity while the CAPM does not, logic dictates that the CAPM should be given twice the weight of the DCF, not the other way around.

Second, in a significant number of cases, the DCF produces patently unreasonable results. The RD's conclusion that the DCF-derived cost of equity is only 8.45% (App. 2, p. 3) is based on a proxy group analysis that includes 18 companies (App. 2, pp. 4-5) with DCF costs of equity that range from a low of 4.79% to a high of 15.24%. The proxy group created by the RD includes the following equity costs that are simply not credible: 4.79% for Ameren, 6.18% for Piedmont, 6.96% for PNM Resources, 7.59% for WCL Holdings, 7.87% for Energy East, 7.87% for NICOR, 8.20% for Xcel Energy 8.35% for Puget Energy, 8.38% for Alliant, 8.53% for PG&E and 15.24% for South Jersey Gas.

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[7] The Generic Finance RD did not establish the 2/3 weighting of the DCF for all time. In fact, it stated:

> In either an annual proceeding to determine a rate of return or in individual proceedings, the 2/3 DCF and 1/3 CAPM convention should be the presumption, but as MI suggests, parties would not be barred from introducing new methods or different weightings. Such parties, however, would have the burden of convincing other parties and the Commission of the relevance or superiority of their proposals.

Generic Finance RD pp. 60-61. As the RD recognized, the Company provided that requisite evidence in this case.

Ameren's cost of equity cannot be 4.79%. This is saying that investors would settle for a 4.79% return from Ameren's stock when they'd get a 5% or better, CD rated from a bank guaranteed and federally insured." Tr. 227.[8] No more proof of the fact that Ameren's cost is not 4.79% is needed than the fact that the Missouri Public Service, which regulates Ameren's Union Electric subsidiary, just recently found that AmerenUE's cost of equity is 10.2% on an equity ratio of over 52%. Case ER-2007-0002, In re Union Electric d/b/a AmerenUE, issued May 22, 2007; 2007 Mo. PSC LEXIS 716 (Mo. PSC 2007). On the other side of the spectrum, it defies credulity to believe that the New Jersey Board of Public Utilities would find that South Jersey Gas had a cost of equity anywhere near 15.24%. Mr. Hanley showed that the average allowed cost of equity by utility regulatory commissions around the country is 10.48% (Tr. 216.) - 213 basis points higher than RD's DCF result. In fact, it is telling that, while the DCF used in the RD produces a 7.87% cost of equity for Energy East – this very Commission found that the cost of equity for Energy East subsidiary NYSEG was 9.55%. Case 05-E-1222, New York State Electric & Gas Corp., Order Adopting Recommended Decision With Modifications (Aug. 23, 2006 at p. 96). Using unrealistic DCF results as components of an analysis can only produce an unrealistic analysis. It simply cannot be otherwise.

Given that the DCF produces manifestly unreasonable results when the CAPM suffers from no such deficiency, if anything, the DCF should be given a subsidiary role. The 2/3 weighting should be given to the CAPM, while the 1/3 weighting accorded to the DCF. The Recommended Decision in the Generic Finance case, in fact, never expected that the CAPM would have a subsidiary and inferior role in perpetuity. It noted:

> The issue comes down to how far the Commission should go in elevating the status of the CAPM, previously used only as a check on the DCF. There is no doubt that the CAPM should figure prominently in the analysis, for it[] includes fundamental information on interest rates and the relative returns needed by stocks in view of those interest rates, and it provides information of what competitive firms are earning. But the proponents of the

[8] Staff witness Capers, on the other hand, believed it was likely that Ameren Corporation had a cost of equity that was 3% or 4.79%. Tr. 1149. The notion that an investor would place his or her money in the equity of a company with a return of that nature when federally insured certificate of deposits are paying higher rates is simply not credible. Tr. 227.

> proposals have simply not shown that the CAPM should be raised all at once to parity with the DCF analysis in the setting of returns on equity.

Generic Finance RD p. 60. The Generic Finance RD was issued thirteen years ago. Since that time, the CAPM has been used in numerous proceedings by this Commission to determine utilities' cost of equity. Until such time as market to book ratios return to more normal levels, the DCF will continue to be an inferior methodology and the CAPM should be afforded primacy.

3. The Recommended Decision's Mixed Industry "Super Proxy" Group Can Be Amended to Produce a Reasonable Result

Finding that the Company's proxy group of gas companies was not large enough and that Staff's proxy group was composed of companies that had a preponderance of electric operations, the RD combined both proxy groups to produce a super-proxy group. RD p. 9. While this is an expedient solution, it suffers from at least two glaring deficiencies. First, as the RD concedes, the Generic Finance case employed a methodology that used gas proxy groups for gas companies and electric proxy groups for electric companies. Id. Second, the large proxy group still contains a significant number of DCF results that are either so low or so high as to be not credible.

The use of a proxy group that includes any electric operation to determine a gas company's cost of equity is a clear departure from the Generic Finance methodology. Moreover, the RD does not show the extent to which Staff's proxy group is unrepresentative of gas LDCs. Of the 13 companies in Staff's proxy group, 11 had minimal gas operations, ranging from as little as 1.02% to as high as only 38.55%. Tr. 211. Moreover, only 86% of Staff's proxy group revenue was even derived from "regulated operations" and 65% of revenue was from electric operations. Id.[9] In contrast, the Company's proxy groups of six and seven companies, while perhaps smaller than optimal, are, at least, composed of companies with significant natural gas operations. In a recent FERC proceeding, this Commission, itself, presented evidence on the cost of equity using a proxy group of only six companies. Tr. 225 – 226. So,

[9] It is interesting to contrast the adamant rejection of the comparable earnings approach in the RD with the fact that, at the same time, the RD embraces the comparable earnings of electric companies.

while Mr. Hanley's groups may be smaller than optimal, they are not unreasonably small and they satisfy the Generic Finance methodology requirement of homogenous industry groups.

The second problem with the proxy group included in the RD is that it continues to include the same unreliable DCF results that Staff's did. The failure to "filter out" clearly aberrant and unreliable results from the proxy group taints the RD's finding as to the Company's cost of equity. And, certainly, the finding in the RD that the Company's DCF based cost of equity is only 8.45%, which is based on those aberrant results, is tainted as a consequence and should not be entitled to any credibility. Again, Company witness Hanley showed that the average allowed cost of equity by utility regulatory commissions around the country is 10.48%. Tr. 216. At the very least, a band of 250 basis points plus or minus around that average rate of ROE (i.e., including results above 8% and below 13%), is the minimum step necessary to eliminate the egregiously anomalous results being generated by the DCF. If that were done, a proxy group composed of eleven companies could be generated. It produces a DCF cost of 9.17% - still low as it includes DCF equity costs above 8% but, at least not burdened by patently absurd results below that level.

4. Over Weighting of the DCF Adds Unnecessary Controversy to the Method for Determining a Utility's ROE.

The over weighting of the DCF method compared to the CAPM unnecessarily has increased the controversy in determining an appropriate ROE in this proceeding. As the RD implicitly recognizes, the CAPM results of the parties in this proceeding are very close together. The table below demonstrates the various costs of equity that result when using a combination of weightings. As can be seen from this table, the differences between the mixed industry super proxy group adopted in the RD and the Company's pure LDC group of seven gas LDCs diminishes to insignificance when the proper weighting is applied to the CAPM and the anomalous results of the DCF are removed.

Summary of ROE Results		
	DCF CAPM Weighting 50/50	DCF 1/3 CAPM 2/3 Weighting
ALJ Mixed Industry Super Proxy /1	9.41%	9.73%
ALJ Mixed Industry Proxy Filtered Between 8% and 13% DCF ROE /2	9.63%	9.78%
NFG Pure Gas LDC Proxy Group /3	9.67%	9.83%
/1 DCF and CAPM Data from Appendix 2 page 3 of RD. 9.41% from Appendix 2 page 3 of the RD. 9.73% = (1/3 x 8.45% DCF) + (2/3 10.37% CAPM).		
/2 Data for DCF (9.17%) and CAPM (10.09%) from Appendix A of this brief. 9.63% = (1/2 x 9.17% DCF) + (1/2 10.09% CAPM). 9.78% = (1/3 x 9.17% DCF) + (2/3 x 10.09% CAPM).		
/3 Data for DCF (9.17%) and CAPM (10.17%) from Appendix A of this brief. 9.67% = (1/2 x 9.17% DCF) + (1/2 x 10.17% CAPM). 9.83% = (1/3 x 9.17% DCF) + (2/3 x 10.17% CAPM).		

When the DCF is properly given the diminished role that the evidence shows it must be given, the Company's cost of equity is seen to lie between 9.73% and 9.83%, using the Generic Finance method. Of course, if the CE approach were to be factored in, as the Consensus Document demonstrated it should be, the higher 13.55% result of the CE method would result in an equity cost in excess of 10%[10]. Distribution continues to maintain that all methods should be employed and that, if they were, the Company's cost of equity would clearly be seen to be above 10%. – indeed, in the neighborhood of 11% as Mr. Hanley demonstrated it should be.

5. Short-term Debt Update

There is no dispute over the Company's proposal to calculate the short-term debt rate. The RD acknowledges that Staff and Distribution agree that the Commission "should update, at the time of its decision, the short-term debt rate that is used to calculate revenue requirements." Accordingly, the RD recommends that Distribution provide its calculation and update "with its brief on exceptions." RD at 12. The information is provided with this brief, in a form believed to be acceptable to Staff, as Appendix B.

[10] 10.79% under ALJ Mixed Industry Super Proxy Group; 10.79% = (1/3 x 8.45% DCF) + (1/3 x 10.37% CAPM) + (1/3 x 13.55% CE); 10.94% under the ALS Mixed Industry Proxy Group filtered for DCF ROEs between 8% and 13%; 10.94% = (1/3 x 9.17% DCF) + (1/3 x 10.09% CAPM) + (1/3 x 13.55% CE); 10.96% under the Company's pure gas LDC Proxy Group; 10.96% = (1/3 x 9.17% DCF) + (1/3 x 10.17% CAPM) + (1/3x 13.55% CE).

IV. EXPENSES

A. Property Taxes

The Company pays town/county taxes, school taxes, village taxes and city taxes. Tr. 1535. Taking into consideration forecasts of property tax increases by various jurisdictions and historical trends, the Company forecasted property taxes using a 3.5% annual increase. Tr. 1537. Staff reduced property expense by $425,000, based on using the "latest known property taxes of $29,934,000" and increasing them by a 3.07% annual rate. Tr. 1358. The RD sided with Staff, finding that a five year trend was a suitable period and that the Company did not present any reasons to expect a fluctuation that would not be captured by the five-year trend. RD p. 27. The RD ignored important facts.

While property taxes were $29,246,000 in the historic test year, actual property taxes for the 12 months ended April 30, 2007 were $30,298,872 – an increase of 3.6% which is higher even than the Company's forecast of an annual increase of 3.5%. As the Supreme Court observed long ago: "If the highly important element of present costs is wholly disregarded such a forecast becomes impossible. Estimates for tomorrow cannot ignore prices of today." Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Com., 262 U.S. 276, 288 (1923). Use of a five-year average is also inappropriate where success in tax certiorari matters and other tax challenges resulted in a temporary decrease in assessment during the period included in the average (Tr. 1586) and there are no pending challenges.

Not only was evidence presented that the actual rate of increase was more than 3.5% already but the Company also demonstrated that expected and announced tax increases makes that rate of increase a certainty. The Company's three most significant taxing jurisdictions are school districts, town and county and the City of Buffalo. Tr. 1536. The largest county in the Company's service territory is Erie County. The County Executive has forecasted that Erie County will see increases of three percent just from revaluing properties. Id. He further forecasted that the tax rate will rise by 2.7%. Id. This is a cumulative rate of 5.7%. This is significant because 70% of the Company's property tax payments are made to jurisdictions within Erie County (Id.) and revaluation of property in Erie County will affect all taxing jurisdictions within that County. Moreover, the fiscal problems besetting the City of Buffalo – an

entity within Erie County - are well known. Id. It is naïve to believe that property taxes in the City will not rise significantly, and in excess of the tax hikes of recent years. Id.

The use of a five-year average might be appropriate where there is no evidence, either way, as to the appropriate rate of change to be expected in the Rate Year. That is not the case here. There is concrete evidence – both in the form of actual property tax increases since the Test Year and reports of tax increases that are already planned – that the rate of increase in property taxes will be 3.5%, or more.

B. Inflation Pool – Health Care and Injuries and Damages

Health care costs and injuries and damages are being addressed together because both are subject to being placed into the inflation pool but the RD treated them differently.

Staff did not dispute the fact that health care costs have been rising at levels that far exceed inflation. Neither did Staff dispute the Company's claim that a 12% increase for health care costs was reasonable. Nevertheless, Staff simply put health care costs in the general inflation pool based on a Commission precedent to treat health care costs in this manner and refused to recognize the increase that was far greater than inflation. Tr. 1271-1272.

In dramatic contrast to its decision to subject health care costs to the general inflation rate, Staff reached out to capture a forecasted decline in worker compensation insurance rates before subjecting injuries and damages to the inflation rate. Staff used a three-year average to forecast the injuries and damages category and then reduced that amount by 10% for such costs before putting it in the general inflation pool. Tr. 1351.

The RD found that Commission precedent mandated that health care costs be placed into the general inflation pool without any adjustment for forecasted increases of 12%. RD p. 21. At the same time, the RD placed injuries and damages in the inflation pool, after adjusting that amount for a forecasted decrease of 10%. RD p. 24. The RD claimed that there was no inconsistency in treating health costs and injuries and damages differently because the Commission has consistently rejected the utilities' "chronic complaint" about the exclusion of known increases in health care costs while the use of a three-year averages of injuries and damages is "normal" and there is a "good basis" for recognizing the

downward trend in worker compensation costs due to recent legislation. Id. With all due respect, this is a distinction without a difference.

The RD recognized that both categories of costs are subject to the inflation pool. That being the case, one would expect that the treatment accorded to both categories of costs would be the same. The RD, however, treats these cost categories differently without any good reason.

Certainly, the quality of evidence supporting the increase to health care costs is far higher than that supporting the projected decrease to injuries and damages. There is unrefuted evidence that health care costs have been rising for years at many times the inflation rate. Tr. 1515. The Company presented a number of different forecasts to arrive at the 12% projection. This projection is conservative because the Company's health care consultant estimated a 14% increase. Id. Staff, moreover, did not dispute that a 12% increase for health care costs was reasonable.

In contrast, the Company demonstrated that using a three-year average produces an under-forecast of injuries and damages. Injuries and damages were $2,464,000 at September 2006 but had grown to $2,912,872 by April 30, 2007 – an increase not captured by Staff's three-year trend. Tr. 1583. More important, there is no guarantee that worker compensation costs will decline by 10%. Staff's projection was supported by nothing more than a newspaper article. Tr. 1351. Staff offered no analysis – either as to how such cost reductions would take place or if they would be applicable to Distribution, at all. The Company offered evidence that projections of savings were very sketchy. Tr. 297. In fact, new guidelines to implement the changes are not even due until December 2007. Id. Consequently, any analysis of potential savings to Distribution under the Workers' Compensation Benefit Increase & Reform Bill is not possible at this time. Id. Moreover, the Company even addressed several elements of the bill that could actually increase, rather than decrease, worker compensation costs. Tr. 298. Therefore, the RD ignored unassailable evidence about rises in health care costs, while crediting claims of worker compensation cost declines that were evanescent, at best. The "good basis" claimed by the RD to recognize declines in worker compensation cost while turning a blind eye to increases in health care costs simply does not exist based on this evidence.

Although the Commission has adopted the general inflation factor as a convenience, the Commission's 1977 Policy Statement on Test Periods in Major Rate Proceedings continues to govern litigated rate cases. It states " [a]ll assumptions, escalation factors, contingency provisions and changes in activity levels should be quantified and properly supported." Policy Statement p. 8. Where, as here, health costs have been rising at many times the rate of inflation for many years and will still rise higher than the rate of inflation in the Rate Year, the Company has met this burden.

The RD's conclusion that health care costs must be placed into the general inflation pool rests on a belief that "the Commission has not departed from the original approach." RD p. 22. That "original approach," however, is based on circumstances so different from today that it is a precedent of only the most flimsy sort. The decision to place health care costs into the general inflation pool arose in a Rochester Telephone case in the early 1980s. There the Commission said:

> The decline in the inflation rate renders reliance on the four-year average unreasonable, for it appears that rate year conditions will be significantly different from those that prevailed over the four-year period. In these circumstances, the Judge's estimate provides the most reasonable projection of rate year insurance expense. The company's exception is denied.
>
> We note, however, that the dispute between the parties over this issue has not been productive and that including this item in the pool of expense to which an inflation factor is applied will save time and effort, avoid unnecessary litigation, and provide a reasonably accurate estimate of this expense. In the future we expect RTC -- and all other jurisdictional utilities -- to treat this expense in a manner consistent with this Opinion.

Case 28695, Rochester Tel. Corp., Opinion No. 84-27, October 12, 1984 mimeo p. 63. Clearly, the decision to inflate health care costs at the general inflation rate was based on the Commission's belief that health care cost escalation in the Rate Year would be different than the historical rate of change those costs had experienced. In this case, on the other hand, the evidence demonstrates that the relentless rise in health care costs will continue apace.

As a general rule, there is no "precedent" that binds the RD or even the Commission to its prior decisions, Consumer Protection Board v. Public Serv. Comm'n, 97 A.D.2d 320, 324 (3d Dep't 1983), and what was reasonable in one proceeding is not necessarily reasonable in the next. The RD's selective

obeisance to non-existent Commission "precedent" is error if, as is the case here, the record supports a different result. As noted above, there is *no dispute* that Distribution's health care costs have increased at rates that exceed inflation, and will increase in the Rate Year at a rate – 12% - that again far exceeds inflation. Use of the general inflation factor for health insurance costs may have been rational at a time when double-digit increases were disputed, Rochester Telephone, supra, but today, after so many years of such costs far exceeding inflation, and in this case with a record that is crystal clear in its support for a Rate Year increase that far exceeds inflation, to rely on "precedent" is not enough. Selective application of such "precedent" under these facts simply exposes the practice of placing health care costs in the inflation pool for what it is: an arbitrary exercise of authority.

Worse still, when juxtaposed with the treatment afforded injuries and damages, the arbitrariness is compounded. In the NYSEG case, the Commission rejected a separate forecast of health care costs on the ground that "no single item should be excluded or 'cherry picked' from the group of expenses that are inflated using a general factor." Case 05-E-1222, New York State Electric & Gas Corp. Order on Rehearing, issued December 15, 2006, p. 11. Selectively "cherry picking" injuries and damage based on the flimsiest of evidence, while refusing to exclude a separate, extensively documented forecast of health care costs, as the RD has done, is simply wrong.

C. Avian Flu Expense

The RD found that the Company should provide an updated status of its preparations for an Avian Flu pandemic, including how costs will be expended and when the Company plans to incur the expenditures. RD p.26. A breakdown of how the expenditures for the flu pandemic would be spent, by cost element, was provided in the Company's initial filing at Exhibit 64, (RLT-3), Schedule 4, Page 3 of 3. As explained in the Company's initial brief, the supplies will be purchased upon Commission approval of the costs during the rate year (NFG IB p. 77). Appendix C included in these exceptions provides a further breakdown of the 24 locations throughout the Company's service territory where the supplies will be delivered. The Company's plan is to distribute such supplies to each location before any flu outbreak in order to avoid a scramble for supplies should an outbreak of Avian Flu occur.

D. Lump Sum Payments

The RD states that the propriety of the lump sum salary payments provided supervisory employees is not in dispute but questions whether there is a double count of such amounts. RD p. 17. The double count would arise if the lump sum payments were accounted for both separately and, again, as part of the base salary increase. Id. The RD, therefore, requested the parties to address the matter of whether the lump sum payments are accounted for twice. Id.

The Company provides salary increases for its employees in two ways, a portion attributable to base pay and a portion attributable to lump sum compensation. Tr. 281. This combination is designed to control base pay, while continuing to offer competitive compensation. Id. The lump sum permits the Company to provide compensation without increasing base compensation and it effectively manages supervisory payroll. Tr. 294

Staff would eliminate lump-sum payments. Staff's actual claim is that adding the lump sum payment to the base salary increase would produce an aggregate pay increase of 6.26%. Tr. 1266. Staff might have a point if this is what the Company did. But the Company did not add the amounts together. In fact, when the entire salary increase is considered, it is only 3.46%. Therefore, it should be clear that there was no double counting.

It is not clear why Staff objected to recognition of the lump sum payments. Staff recognizes that this is a tool by which management moderates wage inflation by dividing annual raises between base and lump amounts. Staff IB p 24. The allocation of any wage adjustment between base and lump sum increases, is determined on an individual basis, only after that individual's total compensation is determined. Tr. 295. Thus if a management employee has a base salary of $50,000 and was awarded a merit increase of 4% starting January 1, 2007, that was allocated 2.5% to base salary and 1.5% to a lump sum payment, then as of January 1, 2007, this employee's new base salary is $51,250 and his lump sum payment is $750, for total 2007 wages of $52,000 – or a 4% increase over his 2006 salary of $50,000.

Now assume this same employee receives a merit adjustment of 3% in 2008 that is allocated entirely to base salary. As of January 1, 2008 his new base salary will be $52,787.50, an increase of just

$787.50 over his 2007 compensation of $52,000. Had Distribution not used lump sums in 2007 and instead allocated the entire 4% increase completely to base salary, the 2008 salary would have been $53,560. Therefore, it can be seen that the use of the lump sum provides the Company with a valuable tool to compensate employees in one year without unduly creating salary escalation in future years. The lump sum can never be a double count because it disappears in the following year.

The table below derived from information provided in Exhibit 64, (RLT-3), Schedule 2, Sheet 4 of 5 is provided to demonstrate that there is also no double count of the lump sum payments.

The total management compensation included in the O&M labor of the Company for the Rate Year was $19,040,447. This amount is composed of annual base payroll and lump sum payments. Lump sum payments were not provided in the payroll information utilized by Company witness Truitt to determine management compensation. In order to reflect the appropriate annual lump sum payments Ms. Truitt included lump sum amounts paid to management in 2006. This historic test year information formed the starting point for the Company's management payroll amount to include in the rate year. Column (B) in the table below summarizes this historic year starting point with total base and lump-sum management payroll of $25,918,673 of which 68.63% or $17,787,985 is included in labor costs. Column (C) calculates the increase in annualized management payroll for the 2007 and column (D) calculates the management payroll included in the rate year for the 12 months ended December 2008. Column (E) highlights the O&M labor provided in the Rate Year including the amounts of $309,367 for lump-sum and $203,420 referenced in the RD. Line 6 of the Table summarizes the annual management labor included in O&M for each year. As can be seen from line 7 the annual labor increase, including lump sum payments, is 3.46% for each year from the historic period to the Rate Year. Because, the aggregate salary increase, including the lump sum payments, is only 3.46%, this presentation demonstrates there is no double count of lump sum in the Company's labor calculation. The Company has correctly reflected both components of management labor costs in the Rate Year and the RD was correct to reject Staff's proposed adjustment.

		Payroll	Annualized Payroll /3	Annualized Payroll 2007	Rate Year Annualized Payroll 2008	O&M Labor
		(A)	(B)	(C = B (lines 1, 2, & 3) x 1.035)	(D = C (lines 1, 2, & 3) x 1.035)	(E= D x 68.63% O&M factor)
1	Base Supervisory /1	$989,868	$23,756,826	$24,588,315	$25,448,906	$17,465,584
2	Executive /2	$120,387	$1,444,644	$1,495,207	$1,547,539	$1,062,076
3	Lump Sum /4		$420,802	$435,530	$450,774	$309,367
4	Lump Sum Other /4		$296,401	296,401	$296,401	$203,420
5	Total		$25,918,673	$26,815,453	$27,743,620	$19,040,447
6	Total O&M after O&M Factor of 68.63%		$17,787,985	$18,403,445	$19,040,447	
7	Annual % Increase			3.46%	3.46%	
/1 Based on management payroll for the pay period of 11/1/2006 – 11/15/2006.						
/2 Based on officer salary allocated to NFGDC's NY Division for the month ended October 2006.						
/3 Base supervisory salary was annualized by multiplying management payroll for the pay period of 11/1/2006 through 11/15/2006 by 24 annual pay periods. ($23,756,826 = $989,868 x 24). Executive payroll was annualized by multiplying officer salary allocated to NFGDC's NY Division for the month ended October 2006 by 12 months. ($1,444,644 = $120,387 x 12).						
/4 Lump sum payments are provided as separate payments in addition to base salary. As cited at page 8 Ms. Truitt's direct testimony (Tr. 1510), lump sum payments were made to management on January 2006. Other lump sum payments were provided to individual management employees receiving promotions throughout the year.						

E. Top Hat Retirement Benefits

Top Hat benefits are provided to certain employees to compensate for benefits that are lost, either through IRS limits or through participation in the Company's deferred compensation plan. Tr. 442. This benefit has been in existence without question since the 1980s. Id. Staff proposed to eliminate the benefit based on incorrect and specious grounds. Staff claimed that the benefit is "excessive" because the IRS does not allow a tax deduction for the benefit. Tr. 1267. The Company refuted this claim. Tr. 1445. See also Internal Revenue Code § 162(a)(1). That was the sole basis for Staff's claim that the benefit is excessive and it is wrong.

Staff also contended that the Company made no showing why the Top Hat benefit should be paid to executives. Tr. 1268. The Company demonstrated that executives were not the only recipients of the benefit. The majority of recipients were non-officer retirees. Tr. 1444. The few officers that are

recipients of Top Hat benefits are not members of the Executive Retirement plan. Id. Staff contended "if Distribution granted such a benefit to its executive employees, Distribution would have a realistic expectation that it would be offset by productivity gains." Tr. 1268. This claim is not rational. As stated previously, the benefit has been in place since the 1980s, is being paid largely to non-officer retirees and is intended merely to make a recipient whole for retirement benefits that were previously earned but which would be lost due to IRS regulations on income limitation or deferred compensation. Therefore, additional productivity could not reasonably be expected to result from such payments, and especially not in those instances where the employee is already retired.

The RD found that no rate allowance should be provided because the Company has failed to provide a better explanation of how the program functions and operates in conjunction with other forms of management compensation and that the amount sought is reasonable. RD p. 18. This is an inappropriate standard. The Top Hat expense has been in place since the 1980s. It is entitled to the presumption of reasonableness that attends all of the Company's expenses until they are challenged. Staff then challenged that reasonableness based on specific grounds and the Company refuted every one of those grounds. It is not appropriate to now claim, as the RD does, that, having refuted Staff's contentions, the Company is required to justify, anew, the Top Hat expense on grounds never anticipated. If that were the standard, rate cases would become chaos.

Top Hat benefits are only $65,000. Tr. 1443. They are paid mostly to non-officer retirees to make up for retirement benefits that would have been paid but for IRS limitations or participation in deferred compensation plans. For the few officers that receive them, again, they simply make up for earned retirement benefits that would otherwise be lost. Top Hat benefits thus stand for the simple proposition that an employee should earn the retirement benefit associated with his or her salary. It was error for the RD to have denied recovery of them.

F. Depreciation Expense

The Company proposed the following changes to depreciation: change H-curves to Iowa curves; change the whole life method to the remaining life method and replace the 70-year average service life of

plastic mains with a 55-year average service life. In the case of Iowa curves and remaining life proposals, the RD rejected them, finding that the Commission was not amenable to making these changes in the NYSEG case. RD p. 39. In the case of plastic mains, the RD found that there was insufficient evidence to justify any change. Id. The RD also adopted several of Staff's proposals to harmonize the service lives of meter and house regulator stations. Id. The Company excepts to these findings.

In the case of Iowa curves, the evidence is clear that they are used exclusively in 49 of 50 states. Tr. 306. Indeed, even in New York – the sole holdout for H-curves – Iowa curves are used for some companies. Id. Furthermore, Iowa curves allow for a more appropriate statistical comparison of life characteristics for gas utilities than do the H-curves that were developed for telephone assets. Id. Staff's own exhibit shows that Iowa curves have been approved for Central Hudson and Keyspan and, in addition, National Grid has Iowa curves. Tr. 326. No witness disputed the evidence that Iowa curves are superior to H-curves for gas companies. Unless some compelling reason is articulated to justify New York being out of step with every other state regulatory commission in the country, Iowa curves should have been adopted.

In the case of the Remaining Life Method, the evidence demonstrates that it assures full recovery of all capital investment in a ratable fashion that is more consistent with the life estimates in place. Tr. 307. In contrast, the Whole Life Method has no checks or balances to assure full recovery. The flaws of the Whole Life Method without a reserve true up can magnify over time and the inclusion of a reserve true up is an unnecessary burden. Id. No party disputed the superiority of the Remaining Life Method. Moreover, the impact of any change from Whole Life to Remaining Life is small. Company witness Spanos explained that, of the proposed annual depreciation expense increase, only approximately four percent is due to the methodological change for the Remaining Life Method. Tr. 328. He showed, in fact, that for the Rate Year, the Remaining Life Method actually produces less depreciation expense for all functions except General Plant, where several asset classes are greatly under-recovered. Id. Mr. Spanos also provided an example that showed that the Remaining Life Method is superior for mass asset

classes. Tr. 331-333. Given the demonstrated superiority of this method and the minimal cost of adopting it, the Remaining Life Method should have been approved.

In the case of the average service life of plastic mains, the RD rejected the Company's proposal to use a 55-year average service life, incorrectly assuming that there was more evidence to support the existing 70-year average service life. RD p. 40. There is not. There is only a bit more than 30 years experience with plastic mains (Tr. 309), so statistical analysis is slender regardless of the average service life chosen. Thus, the lack of support for a 55-year life is no less than for a 70-year life. Nevertheless, there are good reasons to favor the Company's 55-year life proposal. First, the majority of other gas utilities use average service lives between 50 and 60 years for plastic mains. Id. For example, the ASL for plastic mains adopted by the PA PUC for use in Distribution's Pennsylvania Division is just 57 years. Tr. 343. Further, the unique characteristics of Distribution's service territory militate in favor of using a shorter average service life. The environmental and geographic conditions favor a shorter life, as does the experience with main relocations. Tr. 309-310. Moreover, an analysis of the data for plastic mains favors the use of 55-R3 survivor curve and a 55% negative net salvage. Tr. 319-320.

The oldest plastic main on the system is no older than 38 years. Tr. 1243. When plastic mains were first installed, it was felt that they would last a very long time because they did not suffer from corrosion, as metal mains did – hence the 70-year ASL. While that was a logical assumption, it was also mistaken. Actual experience has shown that early vintage plastic main suffers from brittleness that has produced leaks and failure. Tr. 344. This has been explicitly recognized by Staff's Safety Panel, which wants early vintage plastic main replaced pursuant to its Safety proposal. Tr. 1186. Clearly, if it is imperative to replace plastic main that is no older than 38 years, a 70-year ASL for plastic mains is too long. The Company's proposed 55 year ASL for Plastic Mains should have been approved.

Finally, the RD adopted Staff's proposal to use the same ASLs for meters and house regulators, finding it "rational" because installation costs should have the same average service lives as the facilities with which they are associated. RD p. 40. While, perhaps, "rational," this assumption is contrary to the evidence. Mr. Spanos determined that the life characteristics for accounts 380, 382 and 384 are

comparable and should not be separated. Tr. 339. He also demonstrated that quite often, the meter or house regulator is retired or replaced prior to the time that the associated installation is retired. Tr. 340. Therefore, installation costs for meters and house regulators would not be expected to have the same life characteristic as the meter and house regulator with which they were originally associated. Id. Staff's proposal should have been rejected.

With renewed concerns about infrastructure replacement, setting appropriate depreciation rates has risen to greater importance. The RD should not have rejected the Company's proposals, which were supported by the evidence and consistent with well-established methodologies.

V. RATE BASE

A. Pension Payments

1. The Pension Reserve Debit Balance Should Be Included in Rate Base.

In explicit conformity with the Policy Statement on Pensions and OPEBs, Distribution sought rate base treatment for its share of pension payments that National had made in response to a looming pension under-funding problem identified by its actuary. Despite the fact that the record demonstrates that the payments were both reasonable (indeed, necessary) at the time and have reduced the need for rate relief by over $5 million on an annual basis, the RD concluded that the Company's act was not a matter for "praise or consternation" and denied rate base treatment of the debit balance. RD p. 51. The RD, additionally, without any consideration of the actual financial condition of the pension plan, appears to adopt Staff's recommendation that the Company cease funding its pension and instead use the full amount of its annual pension rate allowance to write down the pension internal reserve balance. It further recommends that any carrying charges on the internal reserve debit balance should be at a short-term rate of interest on such payments. RD p. 51. This result reached in the RD should be reversed because it ignores the record, fails to follow the Policy Statement and misstates the Company's actions with regard to the ratemaking previously sought for the internal pension reserve.

In 2002, National's actuary indicated that, due to fallen interest rates and dreadful stock market performance, its pension fund was underfunded[11] and would require cumulative additional funding of $229 million – almost one quarter of a billion dollars - in 2006 and 2007 in order to restore the trust to proper funding status. See Exh. 61. Faced with this looming financial crisis, at a cost to itself in the form of reduced earnings, the Company made additional payments to its pension fund over the next several years.[12]

Moreover, those payments "failed safe" for ratepayers because pension expense is now much lower than it would have been had the payments not been made. Because National made the payments earlier than required under ERISA, they not only restored the funded status of the pension trust but they have earned returns commensurate with the improved performance of the stock market. Under FAS 87, this directly reduced the pension expense borne by ratepayers.[13]

The Policy Statement on Pensions and OPEBs[14] permits, without limitation, pension payments in excess of a rate allowance to be afforded rate base treatment or to accrue interest. The Order adopting the policy statement notes that "[c]ompanies seeking to accrue a carrying-charge on debit balances must petition for Commission authority or seek such approval in a rate proceeding." Pension Policy Statement at 20. The Pension Policy Statement, itself, states in footnote 3 on page 6:

> A debit balance can occur only when management, at its discretion, decides to make contributions in excess of rate allowances or it accrues a negative pension expense. In

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[11] The underfunding problem was a well-known, national concern at the time. The ALJ was presented with an article from the Buffalo News dated October 28, 2002 which confirms that the problem was not limited to National and its subsidiaries.

[12] The payments, to be made over four years, were originally calculated to restore the fallen value of the pension fund. National expected that it would need to fund the then upcoming 2006 ERISA minimum payment of $144 million. It planned to do so with annual payments of $35 million in each of fiscal years 2003 - 2006. Tr. 1434-1435. As the stock market performance improved and interest rates rose National did reduce funding. The initial annual payments of $35 million were reduced to $20 million and then to $16 million. Exh. 63, p. 6.

[13] Company witness Bauer demonstrated that the payments that were made have already generated additional returns of $22.1 million. Tr. 1436. As a result, pension expense for the Rate Year is approximately $4.9 million lower than it otherwise would have been had the payments not been made. This translates into savings of about $5.2 million annual revenue requirement. Id.

[14] Statement of Policy and Order Concerning the Accounting and Ratemaking Treatment for Pensions and Postretirement Benefits Other Than Pensions, issued September 7, 1993. ("Pension Policy Statement").

> rate proceedings, companies may seek prospective interest accruals or rate base treatment for debit balances.

Because the payments both averted a crisis and reduced rates for customers, the Company seeks rate base treatment of its internal pension reserve in order to be made whole for those payments.

In denying the Company's request for rate base treatment, the RD both proceeds from a fundamental misconception about the Pension Policy Statement and relies on several, important, factual misunderstandings.

First, the RD states that the amount the Company seeks to have included in rate base is $34.6 million. RD p. 49. It is not. The correct number, as Staff pointed out in its initial brief, is $20,786,582. Staff IB p. 28. Furthermore, the Company will be writing down the balance of the internal reserve in rate base by $5.9 million each year. This means that, while the revenue requirement benefit of approximately $5.2 million will remain the same, the share of revenue requirement due to the rate base treatment will fall as a result of the continuing write down of the debit balance of the internal reserve. Id.

Second, the RD states that the Company "departed from the Commission's policy statement guidance for pensions and other post-employment benefits." RD p. 51. This is categorically not the case. As noted above, the Policy Statement explicitly provides for situations where payments are made to pension trusts in excess of the rate allowance and specifies that companies may petition for rate base treatment in such cases.

Third, the RD fails to accommodate the facts to the Pension Policy Statement in any meaningful way. Clearly, the Pension Policy Statement allows rate base treatment of payments that exceed a company's rate allowance. Here, the facts demonstrate, without question, that the Company's payments produced an annual revenue requirement that was $5.2 million less than it would otherwise have been had the payments not been made. Therefore, not only were the payments made to avert a pension funding crisis but they also produced tangible benefits to Distribution's customers in the form of lower rates. As the RD points out, MI recognized that the Company acted in the best interests of its customers and its actions provided tangible benefits to them. RD p. 50.

The Company submits that, if there were ever a textbook case for allowing the rate base treatment explicitly provided by the Pension Policy Statement, it is this one. The payments made by National reduced its earnings in the years they were made. Therefore, there was no reason for National to have made the payments unless they were absolutely necessary. It would be one thing if the payments were necessary but served to increase rates. But, here, National's action in making those payments both averted a crisis and produced lower rates. If this combination does not justify the rate base treatment permitted in the Pension Policy Statement, then rate base treatment could never be justified. But if rate base treatment for payments that were necessary and reduced rates was unavailable, this would render the language of the Policy Statement meaningless.

Fourth, the RD claims, based on Staff's arguments, that the Company "has the flexibility to use [$16.1 million received in rates for pension expense] to fund the external pension reserve or reduce the internal reserve pension balance." RD p. 51. The Company interprets that passage to be a recommendation that it cease funding its pension rate allowance until the debit balance is eliminated. Such a recommendation is perplexing in that it gives no consideration to the actual finances of the pension trust and how they in turn affect future pension expense. The plan's active participants continue to accrue additional pension benefits (i.e., service cost[15]), the cost of which needs to be funded to the trust at some point in time. If the Company doesn't fund that service cost as it is accrued, it will either have to make higher contributions in subsequent years or cross its fingers and hope for outsized market returns to absorb the increase in the plan's benefit obligation. Mr. Bauer demonstrated that the timing of pension funding has a meaningful, positive impact on future pension expense. The Company has determined to

[15] For example, as shown on page 91 of National's 2006 Form 10-K, active participants accrued $16.4 million of service cost for the year ended September 30, 2006. Distribution is roughly 60% of the plan, so its share of National's service cost for that year is approximately $10 million.

use $5,897,475 of the rate allowance to reduce the debit balance each year because it is a measured response to eliminating the balance over time. See Exh. 26, DPS 415, p. 2. By continuing to fund its pension at a modest level that is in line with the plan's service cost, the Company effectively balances two competing issues in that it: 1) makes significant progress in reducing the debit balance in the pension internal reserve, and 2) proactively addresses the funding of new benefits earned under the plan (which in the long run will lower the overall pension expense borne by ratepayers).

Fifth, the RD's decision to disallow rate base treatment rests in large part on the mistaken belief that the Company did not seek to address the ratemaking for the payments "for an extended period of time." RD p. 51. An increase in pension expense (which had the effect of slowing the growth of the internal reserve balance) was explicitly recognized in the extension of the rate plan approved by the Commission on September 18, 2003. Case 00-G-1858, National Fuel Gas Distribution Corp., Order Establishing Rate and Restructuring Plans, issued September 18, 2003, p. 7. More important, the RD is in error when it fails to acknowledge that the Company specifically asked for rate base treatment of the debit balance in its last rate filing -- a fact recognized in the Joint Proposal in that case:

> The Pension and OPEB Policy Statement recognized that regulated companies may provide funding to Pension and OPEB costs in an amount greater than the rate allowance. In such circumstances, the Company will have a pre-paid debit balance in its internal pension reserve. The Pension and OPEB Policy Statement recognized this potential circumstance and permitted companies to either petition the Commission to apply interest to this balance or include the balance in rate base in a rate case filing. In its filed case, the Company included the balance in its claim for rate base. In this Joint Proposal, the Signatory Parties agree that the debit balance in the internal pension reserve shall be excluded from rate base. Instead, the Signatory Parties agree that interest will be accrued at the pre-tax rate of return of 11.31% on the debit balance, as provided in Appendix B.

Case 04-G-1047, National Fuel Gas Distribution Corp., Order Establishing Rates and Terms of Two Year Rate Plan, July 22, 2005, Joint Proposal at p. 11. Therefore, not only did the Company seek rate base treatment in its rate filing immediately preceding the instant filing, but the parties to that Joint Proposal agreed that the debit balance should earn a pre-tax rate of return (which is tantamount to rate base treatment).

While the RD seeks to couch this matter in terms of a "reward" or "penalty," Distribution is not seeking a reward or an incentive for its actions. By asking for rate base treatment, the Company is simply seeking recompense for the carrying costs on the funds expended to make the additional pension payments. Here, the revenue requirement is about $5.2 million lower than it would have been had the payment not been made. Given that the rate base treatment requested by the Company would increase rates by $2.8 million, the difference is $2.3 million. This means that, even with the rate base treatment sought here, ratepayers are $2.3 million better off in the Rate Year as a result of the incremental funding. Tr. 1436-1437. This is not a one-time benefit. The incremental assets in the trust will continue to earn a return into the future. Tr. 1437.

The RD, however, would exclude the payments from rate base entirely and provide only a short term interest rate. When rate base treatment is denied, a company must absorb all the carrying costs of the money expended. Denial of rate base treatment, clearly, is punitive. Denying the Company rate base treatment of the internal pension reserve – if adopted – would send a clear message to utilities and their investors that responsible, long-term actions – even where they benefit ratepayers – can and will be punished by denial of the reasonable carrying costs of the payments. No other conclusion can reasonably be drawn.

Even providing a short-term rate on the balance is still punitive. The Company's expenditures are not funded solely through short-term borrowings. Expenditures are covered by debt, both long and short-term, and by equity. Moreover, the RD fails to recognize that had the internal reserve contained a credit balance, the Company would be required to pay its customers interest on the balance at "the company's latest authorized pretax rate of return even if the funds representing the credit balance were simply a substitute for short-term borrowings." Pension Policy Statement, App. A, p. 6. Fundamental fairness requires that if the Company must pay interest to its customers at the pretax rate of return, then the Company should earn interest at the same, pretax rate of return – not a short-term debt rate.

Here, National, in extraordinary circumstances and at a cost to itself, made payments to an under-funded pension plan to forestall a looming funding crisis caused by an historic downturn in financial

Staff's proposal to exclude interest accrued during Fiscal 2005 is directly contrary to the calculation methods shown on Appendix B to the Joint Proposal.[18] It should have been rejected by the RD.

B. Materials And Supplies In Inventory

Staff claimed that the Company incorrectly applied an inflation factor to Materials and Supplies ("M&S") in Inventory, arguing that Distribution's actual historical and 12-month rolling averages of Materials and Supplies balances are stable or decreasing. Tr. 481; Exh. 41, GRP-4. Staff would remove the inflation adjustment, thereby reducing rate base by $379,000. Tr. 481. The RD agreed with Staff, finding that the most recent result would be a good proxy for the Rate Year without applying inflation. RD p. 52.

The RD relied on a "trend since early 2005" to conclude that M&S balances are declining or "apt to remain steady." Id. Yet the exhibit on which the RD relied shows no such "trend." That exhibit demonstrates that M&S levels have risen from approximately $3.3 million in January 2000 to approximately $5.7 million in January 2007 - many times the inflation rate. Moreover, although M&S balances fell to slightly over $5 million in mid-2006, they rebounded to almost $6 million recently (Exh. 41, GRP-6) – additional evidence of inflationary pressure.

Furthermore, the result reached here is irreconcilable with the result reached by the RD to forecast property taxes. Recall that, there, the RD adopted a five-year trend to forecast property taxes, where the rate of annual increase fluctuated from year to year. RD pp. 26-27. Here, in dramatic contrast, the RD forecast M&S balances on the basis of a one-year downward trend that had already reversed itself. We have demonstrated why it is inappropriate to use the five-year trend for property taxes where the increases in the Rate Year are already known with reasonable certainty. But, in the case of M&S

[18] Mr. Wojcinski's claim that "it would be retro-active in nature to allow recovery of interest prior to the commencement date" (Tr. 1345), is a proper exposition of neither the law nor the Joint Appendix. It is clear that the Joint Appendix intended that the Company earn interest on the reserve debit balance established in Fiscal Year 2006 and that such balance was intended to include interest accrued in for all of Fiscal Year 2005. If Mr. Wojcinski were correct, there would be no need for the Appendix to have included a full year's interest accrual for Fiscal Year 2005.

balances, where the increases are not known and the balances have fluctuated, the most reasonable result is either to use a five-year rate of increase or the inflation rate, as the Company did.

VI. RECOVERY OF CIP COSTS

The RD rejected Distribution's proposal, supported by Staff (Staff IB at 63) and CPB (CPB IB at 25-26), to allocate CIP costs to large-volume commercial and industrial customers. RD at 58. The rejection was not with prejudice, but instead was recommended on an interim basis (the Rate Year) while "the matter is . . . considered in greater detail in the generic, statewide proceeding that the Commission initiated in May 2007." RD p. 58. Nevertheless, the RD determined that, for the time being, MI's clients should be relieved of any responsibility for paying for CIP costs unless "the parties . . . refine their positions to demonstrate the true and full merits of running such programs with the support and involvement of business and industry or without them." Id.

Distribution disagrees with the RD's assumption that this proceeding lacks a sufficient record upon which to reach a decision regarding allocation of CIP costs. The record, in fact, provides a compelling argument in favor of allocating costs to large-volume commercial and industrial customers: they stand to gain the most, *by far*, from effective conservation. Dist. RB at 14-16.

The resolution crafted in the RD appears to be based on an overly-constrained perception of what constitutes program benefits for purposes of cost responsibility. To MI, cost responsibility arises solely from a customer's eligibility to participate directly in a rebate or other assistance program under CIP. If, as MI believes, a large-volume customer is not eligible to receive a rebate, then that large-volume customer should not be expected to pay for CIP costs.

Distribution, Staff and CPB collectively take a more expansive view of what constitutes program benefits. Staff IB at 63; CPB IB at 26. Distribution showed that MI's customers have the most to gain from effective conservation for the simple reason that they consume more gas. Indeed, from the narrow perspective of an individual customer cost/benefit analysis, large customers achieve the highest return for their "investment" in gas conservation programs such as CIP. Dist. RB at 16. If these large users are

relieved of cost responsibility, then they gain even more, albeit from the efforts, and expenditures, of other customer classes.

The RD did not determine that the evidence failed to support the arguments advanced by Distribution, Staff and CPB for general funding of CIP. It did not find that Distribution failed to meet its burden of establishing the reasonableness of the Company's proposal to include large volume customers in the funding mechanism for CIP. Instead, the RD decided essentially to ignore the evidence, or at best downplay it to the detriment of smaller customers, and recommend that the Commission consider the matter in the generic EPS proceeding.

The Commission has already determined that implementation of the CIP for this coming winter will not be constrained by the EPS proceeding. Case 07-G-0141, Order Adopting Conservation Incentive Program (issued September 20, 2007). While the RD properly must consider matters of policy in its evaluation of the issues in this proceeding, at this point there is no established "policy" for an energy efficiency portfolio standard. There are undeveloped proposals under consideration in the EPS proceeding. Among those proposals is one to exempt large volume users from cost responsibility, and one (or more) to require large volume users to share the costs.[19] These proposals, however, are just that: there is no record in the EPS proceeding, and no evidence. In this proceeding, the evidence supports the allocation of CIP costs to large volume customers. The principal active parties advocate allocation of CIP costs to large volume customers. The only party opposed to it is MI, which despite its opposition apparently did not find the Company's proposal so offensive as to sponsor a witness or submit its own evidence proposing a different result.[20]

It is appropriate to approve general recovery of CIP costs here, but subject to the outcome of the generic EPS proceeding, an approach that would follow the Commission's usual practice when it is confronted with a discrete issue in a rate case while a generic proceeding addressing the same issue is

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[19] Case 07-M-0548, New York Department of Public Service Staff Preliminary Proposal for Energy Efficiency Program Design and Delivery (August 28, 2007) at 84-85.

[20] To be fair, MI's interest in CIP may be tempered by the fact that large volume customers receiving service under negotiated rates would be exempt from CIP charges.

pending. MI is a party to the EPS proceeding and is capable of defending its clients' interests there. In this case, however, the record supports general funding for CIP costs, and MI simply failed to show otherwise. The Company's proposal, supported by Staff and CPB, should be approved.

VII. PENALTIES

In this litigated rate case, Staff proposed a number of so-called service and safety "incentive" standards. In some instances, the precise measurement of the various standards were simply continued from earlier programs that had been agreed to as a result of settlements that created incentive rate plans. In other cases, the measurements were new. In all cases, failure to meet the standards would result in penalty payments. In no instance would meeting or exceeding the standard produce an incentive reward payment.

The RD accurately summarizes the Company's objection to the imposition of Staff's proposed safety and service standards. The standards vary from utility to utility in the state without any rational reason for the variance.[21] The performance thresholds have no basis in law or regulation. In other words, there is no objective regulation or law from which the standard is derived. In the case of the safety standards, in particular, there has been no showing by Staff that they advance safety in any way. In fact, in some cases, such as main replacement, the standards may have a perverse safety effect –potentially causing the Company to replace perfectly fine bare steel main to avoid a penalty when the dollars should have been spent to replace a leaking plastic main. In the case of the service standards, the Company might be penalized when it is providing a much higher level of service than a neighboring utility. Save in one category, the standards – both safety and service –simply lack any objective measurement. And in the one category where there is an objective standard – leak emergency response time – Distribution's

[21] Indeed, in many, if not most, cases, the standard is derived from the individual company's actual performance. Thus a company is "benchmarked" against its own performance and driven to ever escalating performance, regardless of the performance of its peers.

performance soars well above every other utility except one, with which it shares excellent performance ratings.

The RD also accurately summarizes the Company's position that one may search the Public Service Law ("PSL") in vain to find any authority for the Commission to assess penalties for the violation of service and safety standards. Indeed, the statutory scheme behind the PSL does not permit the Commission to assess fines. The Commission must bring a penalty action in order to do so and a court – not the Commission – is authorized to levy the penalty. Furthermore, both equal protection considerations and the need for rational decision-making do not permit the Commission to enforce a series of penalty mechanisms in which different utilities are held to different safety and service standards.

Pausing to "take a shot" at the parties for not settling this case and presenting a proposal to the Commission that does include safety and service penalty mechanisms,[22] the RD finds that Staff has not proposed to change the targets and penalties that arose from earlier settlements and it proposes that they remain in place. RD p. 66. The RD goes on to castigate the Company for trying to make this matter "an issue of law by demanding to see the basis of the Commission's authority to establish, on its own, any element of the incentive regulation approach that was previously employed." Id. The RD notes that the Company is meeting the standards, anyway, so it has nothing to worry about. And, it counsels, at such time as a standard might be violated, Distribution can test the Commission's authority at that time. Id.

First, the notion expressed in the RD that the Company is contumaciously thumbing its nose at the Commission and daring it to show that it has the statutory power to order what Staff wants in this area is way wide of the mark. The Legislature, not the Company, has denied that power to the Commission. Second, the fact that the Company might be meeting the standards is not germane to an inquiry as to whether the Commission has the power to impose the standards. Third, a company that fails to challenge

[22] While it is regrettable that a settlement was not achieved, this was not for the lack of trying. The parties had several, unfruitful discussions to attempt to settle this case. Ultimately, however, not every case can be settled. There may, in fact, be times when a litigated outcome has a salutary effect in defining the Commission's view on certain issues or defining policy for the future that may aid in fomenting settlements.

a standard when it is announced may rue the day that it did not immediately challenge that standard and waited until a penalty was imposed. See In re Public Service Com., First Department, 177 A.D. 444 (1st Dep't): aff'd In re New York C. R. Co., 222 N.Y. 541 (1917).

It cannot be seriously questioned that Staff safety and service proposals are penalty mechanisms. While Staff terms it an "incentive" (Tr. 1183), there are no incentives in its proposals. There are only penalties and they are severe. Therefore, Staff has proposed a series of penalties that are essentially "fines" for violations of certain standards of conduct. It simply cannot be argued otherwise.[23] Nor can it be argued that the Commission has any power to levy fines or penalties of this, or any other, nature. "The Commission possesses only those powers expressly delegated to it by the Legislature, or incidental to its expressed powers, together with those required by necessary implication to enable the Commission to fulfill its statutory mandate." Niagara Mohawk Power Corp. v. Public Service Comm'n., 69 N.Y.2d 365, 368-369 (1987). Nowhere in the PSL has the Commission been given the power to levy and collect fines or penalties.[24] In fact, only two sections of the PSL – Section 24 and Section 119-b(8) - even allow for

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[23] In an attempt to recast the safety and service penalties as something other than penalties, Staff resorted to applying labels, including "earnings consequences" and "regulatory liability." As the Company observed, however, any such "earnings consequences" and "regulatory liabilities" will necessarily come in the form of a penalty. Dist. RB at 67.

[24] In settlement agreements, under which safety and customer service penalty mechanisms were adopted, the utility may consent to suffer such penalties in exchange for the benefits of the incentive regulation conferred by the settlement. Without the utility's consent, however, the authority for such a mechanism of penalties is absent. The mere fact that Distribution might have agreed to programs of this nature in a past settlement is irrelevant. The Joint Proposal contained the following reservations:

> It is specifically understood and agreed that this Joint Proposal represents a negotiated resolution of the Company's rates and services for the period of the rate plans contained herein, is intended to be binding only in this proceeding and only as to the matters specifically addressed herein. Neither the Company, the Commission nor its Staff, shall be deemed to have approved, agreed to or consented to any principle or methodology underlying or supposed to underlie any agreement provided for herein.

2005 Joint Proposal, p. 54. Moreover the Joint Proposal goes on to state explicitly:

> None of the terms and provisions of the Joint Proposal and none of the positions taken herein by Signatory Party may be referred to, cited or relied upon by any party in any fashion as precedent of otherwise in any proceeding before this Commission or any regulatory agency or before any court for any purpose except in furtherance of the purposes and results of this Joint Proposal.

Id. The Joint Proposal adopted by the 2005 Order clearly states it is of no precedential value and the Commission recognized this fact.

the potential imposition of civil forfeitures and in both cases, a court, and not the Commission is authorized to levy the penalty. "Defects in the conditions to a statutory power cannot be aided by the courts; if they have not been observed the courts cannot dispense with them, and thus bring into existence a power which the statute only permits when the conditions have been fully complied with." Werking v Amity Estates, Inc., 2 NY 2d 43, 49 (1956); app. dism'd, 353 U.S 933 (1957).

Staff conceded that none of the standards it proposes have been established by law or even regulation. See e.g. Tr. 1215, 1233, 1242. "The rule is well settled that the State may impose fines and penalties for a violation of its statutory requirements, and that the Legislature may prescribe the manner in which they shall be enforced, whether at the suit of a private party, or of the public." People v. Ryan, 230 A.D. 252, 258 (4th Dep't 1930). The Company, however, is in compliance with all applicable safety laws and regulations. Tr. 243. If the Commission were to desire additional regulation in the form of the standards Staff proposes, its remedy lies in obtaining such relief from the Legislature and not with the extra-legal, self-help measures described above.

Furthermore, Staff conceded, and the RD found, that it has applied different standards to different utilities. Staff's scheme, therefore, also fails a basic equal protection test. "An agency of the State denies equal protection when it treats persons similarly situated differently under the law and this difference may be created by the grant of a preference as well as by the imposition of a burden." Abrams v. Bronstein, 33 N.Y.2d 488, 492 (1974)(citations omitted). And, even, if Staff's proposal could clear the equal protection hurdle (it cannot), it would still run afoul of the fact that treating similarly situated utilities differently is inherently irrational and arbitrary. Mtr. of Charles A. Field Delivery Service, Inc., 66 N.Y.2d 516, 518-519 (1985). In fact, because Staff's proposal treats utilities differently based on their own performance and in violation of any uniform standard of conduct, it violates the very purpose for which the Commission was established. Troy v. United Traction Co., 202 N.Y. 333, 340 (1911)("The public service commission was established, among other things, for the purpose of promoting uniformity and consistency in authoritative directions to be given to public service corporations and to constitute a tribunal trained to consider and determine controversies and problems relating to such corporations and to

direct and supervise their relations to and dealings with the public as their patrons."). The failure of Staff to justify the different standards for different companies should have led the RD to reject Staff's proposal. Buffalo Civic Auto Ramps, Inc. v. Serio, 21 A.D.3d 722, 725 1st Dep't (2005); app. den, 6 N.Y.3d 713 (2006).

In their reply briefs to the ALJ certain parties claimed that the Company's arguments challenging the Commission's authority to implement incentive mechanisms with financial consequences for unsatisfactory performance were raised, and rejected, in Case 04-M-0159, also known as the "Stray Voltage Case."[25] Even if the Commission's view of its powers in that case were correct, that case is inapposite. The standards proposed in that case were applicable to every utility equally. Here, of course, the standards applicable to Distribution are different from those applied to other utilities.[26] Moreover, the Commission rejected the utilities' arguments in the Stray Voltage Case that utility consent is needed to implement this form of incentive mechanism finding: "[t]hey are also erroneous in their contentions that, absent the utilities' consent, we may not adopt adjustment mechanisms within the context of performance-based rate plans."[27] Here, even assuming that the Commission were stating a correct legal precept, there is not a performance based rate plan at issue and so the Stray Voltage Case, is, again, inapt.

If the Company believed that Staff's proposals were advanced to address some real or serious deficiency in safety or service, the Company would be trying to work with the Commission to address the matter. But this is clearly not the case. Company witness House, testified that the Company "has a comprehensive program, consisting of many components, to address gas safety issues." Tr. 243. He explained, in detail, the many tools that the Company employs to identify safety projects. Tr. 244-245. One such tool, the Company's PREP program for main replacement evaluation, was even recommended by Staff for use by other utilities. Tr. 245-246; Tr. 1221. Neither could Staff contend that the standards

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[25] Case 04-M-0159, Proceeding on Motion of the Commission to Examine the Safety of Electric Transmission and Distribution Systems.

[26] The Commission in the Stray Voltage Case also claimed that an "incentive mechanism" is not the same as a section 25 penalty and therefore there is no proscription in the PSL against penalizing companies via a rate of return penalty. As noted above, a penalty by any other name is still a penalty.

[27] Id. at 28.

are needed to focus the Company on safety issues. As Mr. House noted, the Company was engaged in a comprehensive program of replacing leaking mains and services well before Staff even suggested such programs. Tr. 247. In fact, in one area that can be objectively measured against other utilities, the Company's performance in responding to leak and order complaints is well above average; indeed it is exemplary. While the utilities in the State are required to respond to 75% of all such calls within 30 minutes (and not all do so Tr. 1232), Distribution responds to over 90% of such calls. Tr. 255.

Company witness Gossel is in charge of customer service. He explained that Distribution has provided excellent customer service in the past, before there was a SQPM, and will in the future, when the SQPM expires. Tr. 117-118. Mr. Gossel further explained that, even though the Company could have missed customer service targets during the pendency of the existing, voluntary SQPM, it did not take advantage of such "loopholes." Instead the Company continued to provide its customary levels of high customer service. Tr. 119. No party challenged Mr. Gossel's statements. Clearly, providing excellent customer service is important to Distribution. Tr. 118-119. Moreover, Staff's Consumer Services Division can easily monitor the service Distribution provides via the Customer Service Performance Indicators that all major gas and electric companies in the State are required to provide to the Director of that Office. Tr. 121. As Mr. Gossel noted, "[t]his report, which covers the vast majority of Distribution's interactions with its customers, provides the Panel with the perfect tool for monitoring the Company' customer service delivery on an on-going basis." Tr. 121.

Perhaps the best exposition of the futility of Staff's effort here was exposed by the juxtaposition of Staff witness Stolicky's testimony with that of Staff witness Lepkowski. Mr. Stolicky has no experience with Distribution's actual operations. Tr. 1212. Mr. Lepkowski does. Id. In the area of excavator damages, Staff was asked specifically what more Distribution should be doing. Tr. 1240. Mr. Stolicky answered merely that the Company had been "a lacking performer." Id. He also admitted that there is no standard in the regulations that the Company has violated. Tr. 1242. Mr. Lepkowski, who spends a considerable amount of his days in the Company's service territory and does have extensive experience with Distribution, could not point to anything the Company should be doing that it is not. Tr.

1241. Instead, he catalogued the many things the Company is doing to protect its facilities. Id. This, in a microcosm, exposes the many infirmities of Staff's penalty based approach. Where a company is doing all it reasonably can, and is in compliance with all regulations, Staff would still impose a penalty for failure to meet some arbitrary standard. This is not enlightened regulation. It is irrational.

The mere fact that the Company agreed to a program of service and safety measures as part of a settlement in a multi-year incentive regulation plan does not confer on Staff carte blanche the right to prescribe such ever escalating standards forever. The Commission lacks the power to impose the penalty provisions that Staff envisions. And, even if the Commission had such power, the exercise of it to enforce inconsistent standards that have not been demonstrated to advance safety or customer service in any way, would not be appropriate. The continuation of such standards, as urged by RD, should be rejected.

VIII. RATE DESIGN MATTERS

A. Minimum Bill Increase

Distribution proposed a minimum bill for residential and general customers of approximately $20.00 per month with a corresponding reduction in the tail block rates by 30 percent to 45 percent. RD pp. 67, 68. The current charge is $13.54. Id. Distribution's cost of service study supported a minimum bill of $30.47. Dist. RB at 86. Removing distribution mains from the calculation, Staff's submitted cost of service is $19.12 per month, nearly equal to the Company's proposed minimum bill, but still well below the Company's cost of service.

There is no dispute, then, that Distribution's cost of service supports a minimum charge of at least $19.12 per month.

The RD effectively ignores the cost of service data and recommends a $2.00 increase over the existing minimum charge. RD p. 68. This would increase Distribution's minimum charge to $15.54 per month, or $3.58 less than the undisputed cost of service. The RD justifies a $2.00 increase on two

grounds. First, because it is "in the range suggested by Staff and CPB and it will move the minimum charge that much closer to the undisputed amount of customer costs that have been calculated for such customers." Id. And second, because "the record is not clear concerning the groups of customers who would be hard pressed to pay the minimum charges for basic service." RD p. 69.

Distribution agrees with the RD's conclusion that minimum charges ought to conform, as much as is reasonably possible, to "the undisputed amount of customer costs that have been calculated for such customers." The RD is wrong, however, in its choice of a $2.00 increase as being somehow reflective of that general rule. The RD provides no independent basis for adopting a value that falls significantly short of the undisputed cost of service. Instead, it appears that the RD sought to strike a compromise, despite the evidence. It also appears that the RD rejected a higher increase in part because of the ALJ's concerns regarding the clarity of the record relating to "the groups of customers who would be hard pressed to pay the minimum charge for basic service." RD p. 69.

The RD's concern about the adequacy of the record arises from a long-running erroneous assumption regarding gas service in Distribution's service territory. In this case as in others, CPB argues that a minimum bill increase would be "very burdensome to low-volume customers." Tr. 613; CPB IB at 9; CPB RB at 18. "Low-volume" customers of concern to CPB are typically cooking-only customers. There are significant numbers of low-volume, cooking-only customers served by downstate utilities, and they have long benefited from CPB's policy to protect cooking-only customers from minimum charge increases. The problem in this case is that Distribution, quite unlike downstate utilities, serves a market composed overwhelmingly of space heating customers. Tr. 682-83. Most low-volume customers in Distribution's territory are not cooking-only customers. They are seasonal dwellings. Tr. 1668; Dist. IB at 86. Ironically, it appears that CPB is advocating on behalf of vacation property owners.

By focusing on CPB's concern over non-existent cooking-only customers, the RD sidesteps the established fact that in Distribution's territory, shifting costs from tail block rates to the minimum bill can be beneficial to many low-income customers. The evidence shows that low-income customers tend to consume gas in amounts well above the average for Distribution's territory. Dist. IB at 86; Tr. 1665,

1667. Staff is familiar with this characteristic of Distribution's territory, inasmuch as it has been made known in connection with low-income assistance programs for a number of years. Tr. 870. Shifting costs from tail block rates to the minimum charge would reduce charges for low-income customers in amounts proportionately greater than savings that would be achieved by customers who consume less, particularly in the coldest winter months when such savings would matter most. Thus to the extent that the RD's recommendation to moderate the minimum bill increase is motivated by a concern over its effect on low-income customers, it is clearly in error. The Company's proposal should be adopted.

B. The "No Harm, No Foul" Rule

Ordinarily, gas marketers managing load for transportation customers are obligated to deliver supplies on upstream pipelines, and distribution utilities, within a tolerance band to avoid incurring an imbalance penalty. As another of the many tools developed to promote retail competition, the no harm/no foul rule was designed to enable marketers serving daily-metered transportation customers to escape individual balancing responsibility if the entire class of daily-metered customers is in balance. In practice, the no harm/no foul rule produces two consequences at issue here. It advantages marketers serving small loads at the expense of marketers serving large loads for the reason that a smaller load that is out of balance is not likely to throw the entire class out of balance. Dist. RB at 90. As a result, smaller marketers, freed of the obligation to scrutinize their deliveries, gain a competitive advantage over large marketers. Id. The no harm/no foul rule also relieves marketers of the obligation to match, as closely as reasonably possible, daily gas deliveries with daily end-use consumption.

Distribution and CPB argue that the "no harm/ no foul" rule should be eliminated. Chief among the reasons for eliminating the rule is that it is contrary to the "objective of [daily transportation service] for marketers to be in balance." Dist. RB at 92. Or as stated by CPB, "[b]ecause of the rule, there is no incentive for suppliers to compete to achieve greater efficiency in load management and, therefore, no pressure to narrow the imbalance tolerance band and reduce its cost to customers." CPB RB at 7. CPB and Distribution also object to the rule because it discriminates in favor of marketers serving smaller loads, as explained above.

Staff and MI support the current program and oppose Distribution's proposal.

The RD correctly recognizes that "it appears to be inequitable that . . . the large marketers are kept to the requirements and the smaller marketers are allowed to ignore them." RD p. 74. To solve the problem the RD proposes that the daily balancing requirements should be applied separately to two groups, "one consisting of the large marketers and another made up of the smaller marketers," with each group enjoying the "benefit of its own 'no harm, no foul' rule." RD p. 74.

Although the RD's proposal would resolve the rule's inequity between large and small marketers, it would also continue to promote lax load management practices by all marketers serving daily-metered customers. It is therefore, at best, only a partial solution.

It is also impractical. The RD's proposal for dual no harm/no foul balancing groups is not suited for the daily-metered transportation market, as it currently exists. With only four marketers serving the daily-metered transportation market, the definition of what is a "large" load or a "small" load for purposes of defining each group would be elusive, and would change with customer load variances. A customer in the large-volume group in one month may wind up in the small-volume group in the next month, depending on consumption activity, producing billing and administration difficulties that would serve no customer's interest.

The Company believes, however, that another solution should be approved. The Company proposes that if its original proposal to eliminate the rule is not approved, that in the alternate, the total class no harm/no foul tolerance range should be changed to 5% but in no event, should an individual marketer be subject to a cash out if its imbalance is less than the current 10% level. By reducing the total class tolerance range to 5 percent, small marketers would have a greater incentive to keep their customers in balance, reducing the inequity experienced under the current model. In addition, the Company believes this alternative solution would preserve the administrative efficiencies of the current single-group model.

IX. RETAINED AND CONTINGENCY CAPACITY

The RD asks each party to explain the issue, the differences in the Company's and Staff's positions, and the significance of treating contingency capacity as the Company suggests compared to what Staff suggests. RD p. 90. Initially, it is important to reiterate that there is "no question presented here concerning the need and usefulness of both forms of capacity;" i.e. reserve capacity and contingency capacity. RD p. 90. Also, there is no issue regarding the customers from whom such costs should be recovered; both the Company and Staff agree that contingency capacity costs should be recovered from the Company's sales, non-large industrial transportation and large industrial transportation customers. The only issue is the proportion of contingency costs to be borne by each group of customers.

The Company should recover contingency capacity costs from sales and non-large industrial transportation customers equally because both categories of customers benefit from such capacity in the form of increased reliability. Therefore, under the Company's proposal sales and non-large industrial transportation customers would pay $0.0526 per Mcf transported for contingency capacity. Large industrial transportation customers would pay a lower rate of $0.0095 per Mcf transported for contingency capacity. The Company believes it is appropriate to charge its large industrial customers a lower rate because of their higher load factor.[28]

Staff proposes that contingency capacity costs be allocated to sales and non-large industrial transportation customers in unequal proportions. As shown in Appendix C, under Staff's proposal the Company's sales customers would pay a higher rate of $0.0779 per Mcf, its non-large industrial transportation customers would pay a lower rate of $0.0101 per Mcf, and its large industrial transportation customers would pay a lower rate of $0.0018 per Mcf for contingency capacity. The price differences reflect the different levels of capacity Staff would assign to each subclass.

The effect of accepting the Company's allocation would be that non-large industrial and large industrial transportation customers would bear their fair share of the costs. That Staff's proposal fails to

[28] See Appendix D for a calculation comparing the Company's and Staff's allocation positions.

achieve such a result is revealed when comparing Staff's reasoning with its calculations. Staff observes that "[c]ontingency capacity is maintained as a backup for the entire design day capacity requirement. . . ." Staff RB at 45. In its calculation of transportation customers' share of contingency capacity costs, however, Staff only includes that part of the design day that is provided from the retained capacity. Staff excludes the transportation customers' base requirements. And yet, Staff recognizes that if a marketer fails, replacement gas is provided from the Company's general supplies. RB p. 45. If, however, general supplies are fully utilized, or unavailable due to failure or *force majeure*, then contingency capacity would be used.

Moreover, Staff's proposal would be destined eventually to self-destruct, because as more and more customers migrate to transportation service, the costs to maintain contingency capacity would increasingly and unfairly fall on an ever-shrinking pool of sales customers.

Generally, therefore, what Staff has failed to recognize is that the Company's contingency capacity is available to all customers to ensure reliability, regardless of throughput. For example, to the extent a marketer should fail to deliver its required supplies, the entire amount of contingency capacity is available to ensure reliability for the Company's transportation customers up to the amount of contingency capacity retained. To the extent there is a capacity or supplier failure, the entire amount of contingency capacity is available to ensure reliability for the Company's sales customers up to the amount of contingency capacity retained. Contingency capacity is available equally, without discrimination, and customers should bear the costs of retaining that capacity equally. Company Witness Clark's allocation is appropriate for the Company's contingency capacity and it should be accepted.

X. 90/10 SHARING MECHANISM

The RD correctly summarized the current symmetrical 90/10 sharing mechanism for large volume transportation customers. RD p. 98. It is a sharing mechanism designed to track variances of large volume customer actual margin revenue from the level imputed in rates. As explained in the RD, if the Company exceeds a target level of transportation revenues, it credits 90% of the revenues to sales

customers, and keeps the remaining 10%. If transportation revenue falls below the target level, the Company surcharges sales customers for 90% of the shortfall, and absorbs the remaining 10%. RD p. 98; Tr. 703-04. In this case the mechanism itself, which has been in effect since 1986, is not in dispute. MI, however, opposes a proposed change to the mechanism.

Because of significant growth in transportation service on the Company's system, the Company proposed to modify the 90/10 mechanism to include sales *and* transportation customers. Tr. 668 – 69. The Company believes that it is no longer appropriate or fair to recover this variance solely from sales service customers. There is no dispute that there has been significant customer migration to transportation service, and that trend is continuing. The result is that the pool of sales customers subject to the mechanism in its current form is shrinking, and will continue to shrink prospectively. It is for this reason that RD is correct in the observation that this "is an important matter" that deserves the Commission's consideration. RD p. 99. Fairness requires that the mechanism be modified, as proposed by Distribution, to include transportation customers.

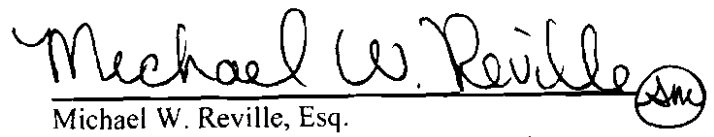
The effect of Distribution's proposal on affected transportation customers will be extremely modest and well within the range of reasonableness. While concerns about rate certainty deserve attention, gas cost fluctuations on a periodic basis routinely exceed the magnitude of change occasioned by the application of a 90/10 credit or surcharge. Furthermore, contrary to MI's concern, for large volume customers receiving service under negotiated rates – many of which are MI's clients - there will be no effect as they are excluded from the mechanism. Tr. 668.

Ultimately the question of whether to approve Distribution's proposal is one of fairness: whether it is it fair to restrict the 90/10 mechanism to a shrinking body of sales customers, while the growing number of transportation customers is exempt. MI, in its opposition, proposes to maintain the status quo, which merely defers the inevitable reckoning for a later date. The Company's proposal is fair and reasonable, and should be approved.

XI. CONCLUSION

For the reasons expressed above, the Recommended Decision should be modified as provided in the Company's foregoing exceptions.

Respectfully submitted,



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Dated: Buffalo, New York
October 18, 2007

Calculation of Return on Equity
ALJ's Super Proxy Group Method Filtered 8-13%
National Fuel Gas Distribution Corporation
Case 07-G-0141

Calculation of GFC Cost of Equity

Merrill Lynch Cost of Market (April 2007 issue)	10.90%	(March 2007)

Treasury Rates [2]	10 year	30 year
October-06	4.73%	4.85%
November-06	4.60%	4.69%
December-06	4.56%	4.68%
January-07	4.76%	4.85%
February-07	4.72%	4.82%
March-07	4.56%	4.72%

Risk Free Rate Average 10yr/30yr (Oct. 06 - Mar. 07)	4.71%
Proxy Group Beta	0.85
Proxy Group DCF ROE	9.17%
Traditional CAPM ROE	9.97%
Zero Beta CAPM ROE	10.20%
Generic CAPM ROE	10.09%
50/50 Weighting DCF with CAPM	9.63%
1/3 DCF 2/3 CAPM	9.78%
2/3 DCF 1/3 CAPM	9.47%

[1] Stock price data from http://finance.yahoo.com/

[2] The Federal Reserve Board, Statistics: Releases and Historical Data
http://www.federalreserve.gov/releases/

[3] Two companies, N.W. Natural Gas Company and NICOR Inc., were included in both Staff's and the company's proxy group, therefore, only five companies were added to Staff's proxy group to form the ALJ's Super Proxy group.
The names of the five companies' names are in italics and are at the end of the list.

Calculation of Return on Equity
ALJ's Super Proxy Group Method Filtered 8-13%
National Fuel Gas Distribution Corporation
Case 07-G-0141

Value Line: Issue 3, March 16, 2007 - Natural Gas (Distribution) Industry
Issue 1, March 02, 2007 - Electric Industry (East)
Issue 5, March 30, 2007 - Electric Industry (Central)
Issue 11, May 18, 2007 - Electric Industry (West)

(B)	(C)			(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
		Avg. Hi/Lo	Avg. Hi/Lo	Avg. Hi/Low							
		10/06 - 3/07	4/07 - 9/07	10/06 - 3/07	EPS	DPS	DPS	DPS	BPS	BPS	BPS
Company	Beta	Price [1]	Price [1]	Price [1]	2010-12	2007	2008	2010-12	2007	2008	2010-12
Alliant Energy	0.95	39.22	40.5717	39.22	2.75	1.27	1.37	1.49	22.85	24.20	28.20
Empire Distric Electric Co.	0.80	24.03	23.39	24.03	2.00	1.28	1.28	1.28	15.80	16.60	18.25
MGE Energy Inc.	0.75	34.49	33.52	34.49	2.55	1.41	1.43	1.47	17.95	18.70	19.45
N.W. Natural Gas Co.[3]	0.75	41.92	46.60	41.92	2.95	1.44	1.50	1.80	22.70	23.95	25.85
NSTAR	0.80	34.46	33.94	34.46	3.00	1.33	1.43	1.75	15.55	16.45	19.75
PG&E Corp.	1.15	45.85	47.23	45.85	3.05	1.40	1.48	1.72	22.45	24.05	28.55
Puget Energy Inc.	0.80	24.63	24.72	24.63	2.00	1.00	1.00	1.20	18.80	19.45	22.00
Wisconsin Energy	0.80	47.04	45.97	47.04	3.50	1.00	1.08	1.30	26.20	27.65	32.75
Xcel Energy	0.90	23.00	22.01	23.00	1.75	0.93	0.99	1.15	14.75	15.25	17.00
Atmos Energy Corp	0.80	31.45	29.81	31.45	2.50	1.28	1.30	1.35	22.45	21.75	25.20
Southwest Gas Corporation	0.85	37.20	33.84	37.20	2.60	0.86	0.86	0.90	22.10	22.75	25.25
Average	**0.85**	**34.84**	**34.69**	**34.84**							
Median	**0.80**										

Appendix A
2 of 6

Calculation of Return on Equity
ALJ's Super Proxy Group Method Filtered 8-13%
National Fuel Gas Distribution Corporation
Case 07-G-0141

Value Line:

(B)	(L)	(M)	(N)	(O)	(P)	(Q)	(R)	(S)	(T)	(U)	(V)	(W)	(X)
Company	# of Shares 2007	# of Shares 2010-12	DPS Growth 2010-12	Retention Rate 2011	Return on Equity 2011	B x R	Increase in Shares	MBR 2007	S Factor	V Factor	S x V	Sustainable Growth	Long-Form ROE
Alliant Energy	109.5	113.00	2.84	0.46	10.00	4.58	0.79	1.72	1.36	0.42	0.57	5.15	8.38%
Empire Distric Electric Co.	31.25	33.00	0.00	0.36	11.13	4.01	1.37	1.52	2.09	0.34	0.71	4.72	9.42%
MGE Energy Inc.	20.70	20.70	0.92	0.42	13.20	5.59	0.00	1.92	0.00	0.48	0.00	5.59	9.22%
N.W. Natural Gas Co.[3]	27.50	29.00	6.27	0.39	11.56	4.51	1.34	1.85	2.47	0.46	1.13	5.64	9.17%
NSTAR	106.81	106.81	6.96	0.42	15.65	6.52	0.00	2.22	0.00	0.55	0.00	6.52	10.59%
PG&E Corp.	377.00	386.00	5.14	0.44	10.99	4.79	0.59	2.04	1.21	0.51	0.62	5.41	8.53%
Puget Energy Inc.	117.00	124.25	6.27	0.40	9.28	3.71	1.51	1.31	1.98	0.24	0.47	4.18	8.35%
Wisconsin Energy	117.00	117.00	6.38	0.63	10.99	6.91	0.00	1.80	0.00	0.44	0.00	6.91	9.06%
Xcel Energy	427.00	435.00	5.12	0.34	10.48	3.59	0.47	1.56	0.73	0.36	0.26	3.85	8.20%
Atmos Energy Corp	89.50	107.00	1.27	0.46	10.16	4.68	4.57	1.40	6.40	0.29	1.83	6.51	10.07%
Southwest Gas Corporation	43.00	47.50	1.53	0.65	10.48	6.85	2.52	1.68	4.24	0.41	1.72	8.57	10.39%
Average													**9.22%**
Median													**9.17%**

Calculation of Return on Equity
NFG Proxy Group
National Fuel Gas Distribution Corporation
Case 07-G-0141

Calculation of GFC Cost of Equity

Merrill Lynch Cost of Market (April 2007 issue)	10.90%	(March 2007)

Treasury Rates [2]	10 year	30 year
October-06	4.73%	4.85%
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December-06	4.56%	4.68%
January-07	4.76%	4.85%
February-07	4.72%	4.82%
March-07	4.56%	4.72%

Risk Free Rate Average 10yr/30yr (Oct. 06 - Mar. 07)	4.71%
Proxy Group Beta	0.86
Proxy Group DCF ROE	9.17%
Traditional CAPM ROE	10.06%
Zero Beta CAPM ROE	10.27%
Generic CAPM ROE	10.17%
50/50 Weighting DCF with CAPM	9.67%
1/3 DCF 2/3 CAPM	9.83%
2/3 DCF 1/3 CAPM	9.50%

[1] Stock price data from http://finance.yahoo.com/

[2] The Federal Reserve Board, Statistics: Releases and Historical Data
http://www.federalreserve.gov/releases/

[3] Two companies, N.W. Natural Gas Company and NICOR Inc., were included in both Staff's and the company's proxy group, therefore, only five companies were added to Staff's proxy group to form the ALJ's Super Proxy group.
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NFG Proxy Group
National Fuel Gas Distribution Corporation
Case 07-G-0141

Value Line: Issue 3, March 16, 2007 - Natural Gas (Distribution) Industry
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(B)	(C)			(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
		Avg. Hi/Lo	Avg. Hi/Lo	Avg. Hi/Low							
		10/06 - 3/01/07	- 9/07	10/06 - 3/07	EPS	DPS	DPS	DPS	BPS	BPS	BPS
Company	Beta	Price [1]	Price [1]	Price [1]	2010-12	2007	2008	2010-12	2007	2008	2010-12
N.W. Natural Gas Co.[3]	0.75	41.92	46.60	41.92	2.95	1.44	1.50	1.80	22.70	23.95	25.85
NICOR, Inc. [3]	1.30	46.81	45.34	46.81	2.90	1.90	1.90	2.00	20.50	21.45	24.10
Atmos Energy Corp	0.80	31.45	29.81	31.45	2.50	1.28	1.30	1.35	22.45	21.75	25.20
Piedmont	0.80	26.48	25.70	26.48	1.55	0.99	1.03	1.15	12.00	12.40	13.40
South Jersey Industries	0.70	32.21	36.22	32.21	3.30	0.98	1.05	1.20	16.05	16.65	18.55
Southwest Gas Corporation	0.85	37.20	33.84	37.20	2.60	0.86	0.86	0.90	22.10	22.75	25.25
WGL Holdings, Inc	0.85	32.20	33.17	32.20	2.20	1.38	1.42	1.45	18.90	19.60	22.00
Average	**0.86**	**35.47**	**35.81**	**35.47**							
Median	**0.80**										

Calculation of Return on Equity
NFG Proxy Group
National Fuel Gas Distribution Corporation
Case 07-G-0141

Value Line:

(B)	(L)	(M)	(N)	(O)	(P)	(Q)	(R)	(S)	(T)	(U)	(V)	(W)	(X)
Company	# of Shares 2007	# of Shares 2010-12	DPS Growth 2010-12	Retention Rate 2011	Return on Equity 2011	B x R	Increase in Shares	MBR 2007	S Factor	V Factor	S x V	Sustainable Growth	Long-Form ROE
N.W. Natural Gas Co.[3]	27.50	29.00	6.27	0.39	11.56	4.51	1.34	1.85	2.47	0.46	1.13	5.64	9.17%
NICOR, Inc. [3]	44.60	45.00	1.72	0 31	12.27	3.81	0.22	2.28	0.51	0.56	0.29	4.09	7.87%
Atmos Energy Corp	89.50	107.00	1.27	0.46	10.16	4.68	4.57	1.40	6.40	0.29	1.83	6.51	10.07%
Piedmont	73.80	71.80	3.74	0 26	11.72	3.02	-0.68	2.21	-1.51	0.55	-0.83	2.20	6.18%
South Jersey Industries	29.60	31.00	4.55	0.64	18.11	11.52	1.16	2.01	2.33	0.50	1.17	12.69	15.24%
Southwest Gas Corporation	43.00	47.50	1.53	0.65	10.48	6.85	2.52	1.68	4.24	0.41	1.72	8.57	10.39%
WGL Holdings, Inc.	48.91	49.00	0.70	0.34	10.19	3.47	0.05	1.70	0.08	0.41	0.03	3.51	7.58%
Average													**9.50%**
Median													**9.17%**

Appendix A
6 of 6

NATIONAL FUEL GAS COMPANY
SHORT-TERM DEBT RATE UPDATE

Bi-lateral Borrowings			
3 month LIBOR average, Sept 2007	5.49% (1)		
NFG spread	0.15% (2)		
NFG rate	5.64%	60%	3.38%
Commercial Paper			
A2/P2 average, Sept 2007	5.63% (3)	40%	2.25%
Blended short-term rate			5.64%
Committed line of credit fees			0.34% (4)
Updated short-term debt rate			5.98%

(1) Per Bloomberg
(2) Per Direct Testimony of David P. Bauer
(3) Per Federal Reserve Board website
(4) Calculated as $560,395 of committed credit fees divided by $163,894,920 of projected short term debt for the rate year - see Exhibit 62 (DPB-2), page 2.

National Fuel Gas Distribution Corporation
New York Division
Avian Flu Supplies by Location

	LOCATION	MASKS	GLOVES	TEMP. DEVICE	SPRAYS etc./CASES
1	APPLETREE CAC	1344	1344	1344	3
2	ARCADE S.C.	336	336	336	1
3	BATAVIA S.C.	1848	1848	1848	5
4	CLARENCE S.C.	3864	3864	3864	9
5	DUNKIRK S. C.	3192	3192	3192	10
6	HONEYOYE S. C.	504	504	504	1
7	JAMESTOWN CAC	840	840	840	1
8	JAMESTOWN S. C.	2016	2016	2016	5
9	LAFAYETTE SQUARE	1344	1344	1344	3
10	MAIN	51,576	51,576	51,576	124
11	MSW-BLDG. 3	1344	1344	1344	3
12	MSW-CONSTRUCTION	5208	5208	5208	13
13	MSW-CUSTOMER SERVICE	11,088	11,088	11,088	26
14	MSW-MATERIALS MGMT.	1512	1512	1512	3
15	MSW-MECHANICAL	2184	2184	2184	4
16	MSW-METER SHOP	2184	2184	2184	4
17	MSW-BLDG. 8	504	504	504	1
18	MSW-TELECOM	504	504	504	1
19	NIAGARA FALLS CAC	504	504	504	1
20	NIAGARA FALLS S. C.	3528	3528	3528	9
21	ORCHARD PARK S. C.	5544	5544	5544	14
22	SALAMANCA	504	504	504	1
23	TONAWANDA S. C.	9,912	9,912	9,912	25
24	WELLSVILLE S. C.	2184	2184	2184	5
		113,568	113,568	113,568	272

National Fuel Gas Distribution Corporation
New York Division - Case 07-G-0141
Contingency Capacity Reconciliation

			Total	Total Sales	Non TC 4.0 Transportation	TC 4.0 Transportation
1	Contingency Capacity Cost	(Exhibit 46, TJC-13, Schedule 1, Page 1)	$ 4,421,668	2,769,127	1,556,591	95,950
	Company Proposal					
2	% Contingency Capacity in Delivery Rates		100%	100%	100%	100%
3	Contingency Capacity in Delivery Rates	Line 3 = Line 1 x Line 2	$ 4,421,668	$ 2,769,127	$ 1,556,591	$ 95,950
			Total	**Total Sales**	**Non TC 4.0 Transportation**	**TC 4.0 Transportation**
4	Total Throughput Subject to RCC Mcf	(Exhibit 46, TJC-13, Schedule 1, Page 1)	92,390,778	52,666,941	29,605,310	10,118,527
5	Contingency Capacity Cost in Delivery Rate $/Mcf	(Line 5 = Line 3/Line 4)	$ 0.0479	$ 0.0526	$ 0.0526	$ 0.0095
6	Contingency Cost Capacity Recovery by Class	(Line 6 = Line 5 x Line 4)	$ 4,421,668	$ 2,769,127	$ 1,556,591	$ 95,950
7	% Contingency Capacity in Sales Rate		0%			
8	Total Contingency Capacity in Sales Rate	(Line 8 = Line 7 x Line 1)	$ -			
9	Total Sales Volume	Line 3 Total Sales	52,666,941	52,666,941		
10	Contingency Capacity Cost in Sales Rate $/Mcf	(Line 10 = Line 8 / Line 9)	$ -			
11	Contingency Cost Capacity Recovery by Class	(Line 11 = Line 10 x Line 9)	-	$ -		
12	Total Contingency Cost Recovery By Class	(Line 12 = Line 6 + Line 11)	$ 4,421,668	$ 2,769,127	$ 1,556,591	$ 95,950
13	Average Rate per Class $/Mcf	(Line 13 = Line 12 / Line 4)		$ 0.0526	$ 0.0526	$ 0.0095

	Staff Proposal					
14	Contingency Capacity in Delivery Rates	Exhibit 42, CP-3, Page 1 of 1	$ 849,171	531,665	298,861	18,645
15	Contingency Capacity in Delivery Rates	(Line 15 = Line 14/Line 1)	19%			
			Total	**Total Sales**	**Non TC 4.0 Transportation**	**TC 4.0 Transportation**
16	Total Throughput	(Line 16 = Line 4)	92,390,778	52,666,941	29,605,310	10,118,527
17	Contingency Capacity Cost in Delivery Rate $/Mcf	(Line 17 = Line 14 / Line 16)	$ 0.0092	$ 0.0101	$ 0.0101	$ 0.0018
18	Contingency Cost Capacity Recovery by Class	(Line 18 = Line 17 x Line 16)	$ 849,171	$ 531,665	$ 298,861	$ 18,645
19	Contingency Capacity in Sales Rate	(Line 19 = Line 1 - Line 14)	$ 3,572,497			
20	Contingency Capacity in Sales Rate	(Line 20 = Line 19/Line 1)	81%			
21	Total Sales Volume	(Line 21 = Line 9)	52,666,941	52,666,941		
22	Contingency Capacity Cost in Sales Rate $/Mcf	(Line 22 = Line 19/ Line 21)	$ 0.0678			
23	Contingency Cost Capacity Recovery by Class	(Line 23 = Line 22 x Line 21)	$ 3,572,497	$ 3,572,497		
24	Total Contingency Cost Recovery By Class	(Line 24 = Line 23 + Line 18)	$ 4,421,668	$ 4,104,162	$ 298,861	$ 18,645
25	Average Rate per Class $/Mcf	(Line 25 = Line 24 / Line 16)		$ 0.0779	$ 0.0101	$ 0.0018
	Difference Between Staff and Company Proposal					
26	Average Rate per Class $/Mcf	(Line 26 = Line 25 - Line 13)		$ 0.0253	$ (0.0425)	$ (0.0076)
27	Total Contingency Cost Recovery By Class	(Line 27 = Line 24 - Line 12)	$ -	$ 1,335,035	$ (1,257,730)	$ (77,305)