83 Pa. PUC 262 Pages: ____

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Missouri Public Service Commission

PUBLIC UTILITIES REPORTS 4TH, 83 Pa. PUC 262

PUBLIC UTILITIES REPORTS - FOURTH SERIES

PENNSYLVANIA

Pennsylvania Public Utility Commission
v.
National Fuel Gas Distribution Corporation

Additional complainants: Kenneth C. Springirth; Earl and Alice Carothers; Anthony Goedecker; John Scurry; Pstachu S. Johut; Viva H. Watson; Robert L. Gaddess; Richard R. Reed; John L. and N. Jean Conlon; Gerald E. Doutt; Eunice M. Porsch; Edna K. Torres; Office of Consumer Advocate; Office of Small Business Advocate; Marcella V. Janick; Walter C. Edwards; Mark Summers; Independent Oil and Gas Association Customer Group; Hospital Council of Western Pennsylvania; George Touris

[PART 1 OF 4]

Exhibit No. 223
Case No(s). GR-2004-0209
Date 6-24-04 Rptr TD

R-00942991 et al.

Pennsylvania Public Utility Commission

83 Pa. PUC 262

December 1, 1994; entered December 6, 1994

SYNOPSIS:
APPLICATION by a natural gas local distribution company for authority to increase rates and charges by $ 15.96 million; granted as modified in the amount of $ 4.754 million, with an authorized rate of return on equity of 11% and an overall return of 9.39%. Commission expresses great concern about affordability of service, given the economically depressed atmosphere in the company's service area. Accordingly, the commission denies requested increases in monthly customer charges and also rejects a proposal for a weather normalization adjustment clause.

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Commissioners Present: David W. Rolka, Chairman Joseph Rhodes, Jr., Vice-Chairman John M. Quain Lisa Crutchfield John Hanger

BY THE COMMISSION:

OPINION AND ORDER

I. INTRODUCTION

A. History of the Proceeding

On March 8, 1994, National Fuel Gas Distribution Corporation ("NFGD" or "the Company") filed Supplement No. 39 to Tariff Gas-Pa. P.U.C. No. 8 to become effective May 7, 1994. This filing contained proposed changes in rates, rules and regulations calculated to produce $ 15,960,000 n1 in additional annual revenues, based upon the projected level of operations for the twelve months ended November 30, 1994. Pursuant to Section 1308(d) of the Public Utility Code ("Code"), 66 Pa. C.S. § 1308(d), the filing was suspended by operation of law until December 7, 1994, unless permitted by Commission Order to become effective at an earlier date.

By Order adopted April 7, 1994, and entered April 8, 1994, we instituted an investigation into the lawfulness, justness and reasonableness of the proposed increase, as well as the Company's existing rates. Formal Complaints against the proposed increase were filed by the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), the Hospital Council of Western Pennsylvania ("Hospital Council"), and Kenneth C. Springirth and several other NFGD customers. The IOGA n2 Customer Group ("IOGA") sought and received permission to intervene in this proceeding, but did not actively participate. The Commission's Office of Trial Staff ("OTS") was directed to participate and filed a Notice of appearance.

The matter was assigned to Administrative Law Judge ("ALJ") George M. Kashi on April 15, 1994 and a prehearing conference was scheduled for and held before ALJ Kashi in Harrisburg on April 27, 1994. Technical evidentiary hearings were held in Harrisburg on June 13, 14, and 15, July 7, 8, and 15, and July 26, 27, and 28, 1994. Additionally, two public input hearings were held; one in

Sharon, PA on the afternoon of June 16, 1994 and one in Erie, PA on the evening of June 16, 1994. The record consists of 1266 pages of technical evidentiary transcript, 128 pages of public input testimony in Sharon, PA, 114 pages of public input testimony in Erie, PA, numerous statements of prepared testimony and numerous exhibits. The record closed on July 28, 1994. Main Briefs in excess of 600 pages were filed by the participants on August 16, 1994, with Reply Briefs, exceeding 300 pages, filed on August 25, 1994. Both NFGD and the OTS petitioned to reopen the record at the time briefs were filed to include in the record certain updated material which had been previously agreed to by the parties. Reopening was granted by ALJ Kashi. Additionally on September 1, 1994 the OTS filed a Motion to Strike Portions of the Reply Brief of NFGD ("Motion"). NFGD filed a Response to the Motion on September 2, 1994 and OCA filed a letter in support of the Motion on September 7, 1994. Upon consideration of the Motion and the response, and for the reasons advanced in the Motion, the ALJ granted the Motion of OTS. Consequently, the last sentence of page 33 and page 37, line 12 to and including page 40, line 2, of NFGD's Reply Brief was stricken.

On October 12, 1994, the Recommended Decision of ALJ Kashi was issued ("R.D."). ALJ Kashi recommended that NFGD be granted an operating revenue increase not to exceed $ 2,261,000, to become effective for service rendered on, and after December 7, 1994 (R.D. at 270). n3 Exceptions were filed by NFGD, the OCA, the OTS, the OSBA, IOGA, and the Hospital Association of Western Pennsylvania. Reply Exceptions were filed by NFGD, the OCA and the OTS.

B. The Company

In his Recommended Decision, ALJ Kashi provided the following information regarding the Company:

National Fuel Gas Distribution Corporation ("Distribution") is a corporation organized and existing under the laws of the State of New York. Distribution is a wholly-owned subsidiary of National Fuel Gas Company ("National"), a public utility holding company duly registered with the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935. National also owns all issued and outstanding shares of common capital stock of its other subsidiaries (Ex. No. 25).

Distribution furnishes gas sales and transportation service to the public in northwestern Pennsylvania and western New York. Within Pennsylvania, Distribution provides gas service in the counties of Armstrong, Butler, Cameron, Clarion, Clearfield, Crawford, Elk, Erie, Forest, Jefferson, McKean, Mercer, Venango and Warren (Ex. No. 25, p. 3).

II. EVIDENTIARY ISSUES

[1] At pages 4-5 of the R.D., ALJ Kashi discusses the applicable legal standards pertaining to the burden of proof in this proceeding. This matter is a general rate increase pursuant to Section 1308(d) of the Public Utility Code, and we, therefore, agree with the citations of ALJ Kashi and his discussion which placed the burden of establishing the justness and reasonableness of all components of the requested rate increase on the Company. See Section 315(a) of the Public Utility Code, 66 Pa. C.S. § 315(a).

III. RATE BASE

A. Plant in Service

Distribution's claimed plant in service, as adjusted for ratemaking purposes, net of customer advances for construction, is $ 298,870,000. This was the final plant in service amount, reflecting all updates and corrections. The claimed plant in service amount reflects the level of plant as shown on Exhibit 108-A, p. 1, adjusted, and to reflect the capitalization of certain software, as proposed by OCA. These adjustments remove from rate base $ 307,000 of post future test year revenue producing plant additions and add $ 399,000 of software.

The major controversy related to Distribution's rate base claim was (1) the inclusion of projected non-revenue producing plant additions through May 31, 1995, the midpoint of the year when rates established in this proceeding will be in effect; and (2) a claim for Construction Work In Progress ("CWIP") of $ 1,654. n4 We address each issue in the order above stated.

1. Plant Not in Service at End of Future Test Year

NFGD's reasons for including plant additions through May 31, 1995 are explained at pages 16-17 of Statement No. 101.

The OCA and OTS objected to the inclusion of post future test year non-revenue producing plant additions in rate base (OCA St. 3, pp. 15-16; OTS St. No. 3, pp. 6-11). The ALJ noted that the principal objections of the OCA and the OTS to including post future test year non-revenue producing plant additions in rate base are that the amounts are estimated, not actual, and that such projected plant additions are not matched to revenues and expenses.

The OTS submits that the Company's claim for projected post-test year plant additions of $ 3,973,000 (net of retirements) and associated depreciation expense of $ 215,014 should be rejected. The OTS asserts that since the claim is based purely on mathematical calculations rather than scrutiny of identifiable construction projects, there is no way that the Company can meet its burden of proof. OTS M.B. at 13. Also, argues OTS, the inclusion of post-future test year plant in rate base would improperly allow the Company a return of and a return on plant which is not used and useful in the public service at the end of the test year, and would violate the ratemaking principle of matching revenues, expenses, and rate base to a test year. OTS M.B. at 17. This, concludes OTS, should not be permitted.

The OTS, through its witness, witness Michael Gruber, proposed the total disallowance of these purported post-test year plant additions. OTS Stmt. 3, pp. 7-8. The ALJ found that Mr. Gruber's adjustment results in a net reduction to the Company's claim for Net Plant in Service at November 30, 1994, of $ 3,972,485 ($ 4,849,792 in post-test year plant additions - $ 877,307 in projected retirements = $ 3,972,485). OTS Exhibit 3A, Schedule 1, column B, line 1. See also, OTS Ex. 3A, Sched. 5, p. 3. The ALJ observed that the corresponding depreciation expense reduction is $ 215,014. Id. at 18. The ALJ noted that since the retirements that are to take place during December 1, 1994 - May 31, 1995 represent assets that are fully depreciated, NFGD also subtracted $ 877,307 from the accrued depreciation at November 30, 1994. The OTS pointed out that if the post-test year additions and retirements are disallowed, the $ 877,307 of accrued depreciation on these retirements should then be added back to the accrued depreciation, as described in Mr. Gruber's testimony. OTS Stmt. 3, p. 10.

According to the OCA, the Company has included in its rate base claim plant that it has estimated will not be in service within the future test year but will be in service within six months of the future test year. The OCA continued that this claim is further broken down into plant which constitutes Construction Work in Progress (CWIP) at the end of the future test year, and plant for which no expenditures have been made at the end of the future test year but which is anticipated to be in service within 6 months of the end of the future test year. The OCA has presented evidence to support each of the two categories described immediately above.

1. Non-Revenue Producing Plant That Will Not Be In Service And For Which No Expenditures Will Have Been Incurred By Future Test Year End.

The OCA observes that the Company has estimated that, within 6 months of the end of the future test year in this proceeding, it will have non-revenue producing plant-in-service in the amount of $ 3.521 million, and it has claimed this amount as an addition to rate base in this proceeding. NFGD Exh. 108-A, p. 1. The OCA continued that NFGD, through the testimony of its witness, Rosetta Brocato, indicated that this amount is estimated based upon certain mathematical calculations. N.T. at 152; NFGD Exh. 108-A-7, p. 2 of 3. The ALJ noted that those mathematical calculations are set forth in NFGD Exh. 108-A-5 and reflect a ratio of actual additions and retirements for fiscal years 1992 and 1993. NFGD Exh. 108-A-5. However, the OCA submits that Ms. Brocato testified that these estimated additions and retirements do not reflect specific projects but are solely based upon mathematical calculations (N.T. at 155). OCA M.B. at 28.

The OCA's witness, James D. Cotton, recommended a disallowance of the projected additions and retirements for the period from December, 1994 through May, 1995. Mr. Cotton proffered the following explanation of the basis for his position:

It should not be allowed in rate base. Not only does the $ 3.5 million not represent used and useful plant-in-service within the future test year, it does not even represent CWIP at test year end, November 30, 1994. No expenditures related to this addition to plant-in-service will have been spent as of the future test year end.

In addition to being speculative, this claim essentially extends the future test year out to May 1995, but in an inequitable manner, since no other ratemaking elements are extended that far out. Thus, rate base, revenues, and expenses, the major components that make up rates, are mis-matched in time. OCA St. 3 at 16.

Additionally, it is the position of the OCA that while the Company clearly identified these additions as non-revenue producing, no effort was made by the Company to determine whether any of the additions would be expense-reducing. The OCA continued that the only testimony regarding whether these additions were expense reducing was provided by Ms. Brocato in her Rebuttal Testimony and that testimony proved unreliable, as brought out on cross-examination. NFGD St. 201 at 2-3; N.T. at 991-95. In particular, the OCA contends that Ms. Brocato could not testify to the circumstances under which mains are typically replaced (N.T. at 991). OCA M.B. at 29. Further argues the OCA, her claims regarding the non-expense reducing characteristic of the plant was apparently based upon the statements of fellow employees, who were not provided for cross-examination (N.T. at 994). Moreover asserts the OCA, Ms. Brocato herself has no experience with the engineering side of NFGD's business (N.T. at 995). OCA M.B. at 29 & 30. Thus, argues the OCA, the Company failed to produce any reliable evidence that plant-in-service added during the period December 1994 through May 1994 is not expense-reducing. Consequently, the Company's position should be rejected.

The OCA argues that the law is clear that only plant which is used and useful in service to ratepayers is appropriately included in rate base in the establishment of rates. See, e.g., Barasch v. Pennsylvania Pub. Util. Comm'n, 516 Pa. 142, 532 A.2d 325 (1987), aff'd Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989). OCA M.B. at 30. However, OCA does concede that the Commission has discretion in applying the "used and useful" standard to include in rate base a utility's investment in plant that will not be placed in service until some time after the end of the test year.

See, e.g. Pennsylvania Pub. Util. Comm'n v. Pennsylvania-American Water Co., R-00922428, slip op. at 8 (April 21, 1993) ["PAWC 1993"].

However, the ALJ observed that in this case, OCA submits that there is no sound rationale for inclusion of speculative post-future test year plant additions based simply upon a mathematical estimate in future test year rate base. R.D. at 10.

On consideration of the positions of the parties, the ALJ recommended the disallowance of the claim. The ALJ cited the testimony of Mr. Gruber, that the Company has selected November 30, 1994 as the end of its future test year, and that it is at this point that revenues and expenses are annualized and plant in service and rate of return is calculated to determine a representative level of income required by the Company to operate. OTS Stmt. No. 3, p. 8. The ALJ found that if post-test year additions are allowed, the balance established by the test year is lost and the matching principle is violated (matching of expenses, revenue, and rate base to the same time period). The ALJ continued that the OTS noted that the Company had included no post-future test year revenues in this proceeding, which would offset the inclusion of additional post-test year claims. N.T. 206-207.

The ALJ further cited Mr. Gruber's testimony in support of his finding that the inclusion of post-future test year plant in rate base would allow the Company a return of and a return on plant not used and useful in the public service at the end of the test year is improper. (R.D. at 11). Further, the ALJ cited Barasch v. Pa. P.U.C., 516 Pa. 142, 162, 532 A.2d 325, 334 (1987), aff'd, 488 U.S. 299, 109 S. Ct 609 (1989) as follows: one of the cardinal principles of this state's public utility law is that, in the setting of rates for services to the public, a utility company is entitled to a return only on such of its property as is "used and useful" in the public service. (R.D. at 11). See also, Pennsylvania Electric Co. v. Pa. P.U.C., 509 Pa. 324, 502 A.2d 130 (1985).

The ALJ continued that Section 102 of the Code, 66 Pa. C.S. § 102, defines rate base as the "value of the whole or any part of a public utility which is used and useful in the public service." Thus, the ALJ concluded that by including admittedly non-used and useful property in rate base, which is derived solely from mathematical calculations rather than scrutiny of individual projects and which is merely calculated to be the value of additional plant in service between December 1, 1994 and May 31, 1995, the Company is clearly violating the "used and useful" principle (R. D. at 11-12).

Additionally, the ALJ relied upon Section 1315 of the Code, 66 Pa. § 1315 which states in pertinent part as follows: [E]xcept for such nonrevenue producing, non-expense reducing investments as may be reasonably shown to be necessary to improve environmental conditions at existing facilities or improve safety at existing facilities or as may be required to convert facilities to the utilization of coal, the cost of construction or expansion of a facility undertaken by a public utility producing, generating, transmitting, distributing or furnishing electricity shall not be made part of the rate base nor otherwise included in the rates charged by the electric utility until such time as the facility is used and useful in service to the public. Except as stated in this section, no electric utility property shall be deemed used and useful until it is presently providing actual utility service to the customers. (R.D. at 12).

The ALJ noted that the Pennsylvania Supreme Court, in Barasch,

supra, 532 A.2d at 338 (1987), ruled that Section 1315 of the Code codifies pre-existing principles of law, which are applicable to all utilities. See also, Pa. P.U.C. v. UGI Corp., 58 Pa. P.U.C. 155 (1984).

The ALJ observed that according to NFGD, its projected post-test year plant addition claim consists entirely of non-expense reducing, non-revenue producing plant, which will be in service within six months after the end of the test year. n5 However, the ALJ found that as stated previously, NFGD's claim is based solely on mathematical calculations rather than an examination of individual projects to ascertain whether a project will actually produce revenues or reduce expenses or whether a projected in-service date is realistic. Furthermore, the ALJ opined that other parties' analysts are also precluded from scrutinizing these purported projects to test the reasonableness of the Company's assertions because there is no listing of projects (R.D. at 13). The ALJ found that without an examination of individual projects, it is not possible for NFGD to meet its burden of proof on its post-test year plant additions claim pursuant to Section 315(a) of the Code, 66 Pa. C.S. § 315(a) (Id).

The ALJ noted that NFGD witness Ms. Brocato contended that the Company's post-test year additions claim was developed by projecting construction expenditures using methods previously accepted by the Commission. NFGD Stmt. 101, p. 16. The ALJ found that while the Commission may have accepted historical ratios to develop test year expenses, he was unaware of any Commission Order which has explicitly accepted NFGD's methodology for projecting post-future test year plant additions (i.e. plant that it is purported to be completed and serving customers from November 30, 1994 to and including May 31, 1995).

The ALJ additionally cited Pa. P.U.C. v. Pennsylvania-American Water Company, 68 Pa. P.U.C. 343, 352, 97 PUR 4th 469 (1988), for the proposition that the cases in which the Commission allowed post-future test year additions have related to the inclusion of specific projects which are to be completed within a short time after the end of the test year. The ALJ continued that, while NFGD has not claimed its $ 3,973,000 post-test year additions as CWIP, the Commission is currently considering a proposed policy statement concerning ratemaking treatment of CWIP. See, Docket No. M-930497; 24 Pa. Bulletin 882-884 (February 12, 1994). The ALJ noted that in this proposed policy statement, the Commission states that in determining whether to include post-test year CWIP in rate base, the Commission will consider, inter alia, whether the CWIP project is reasonably identifiable as nonrevenue producing and nonexpense reducing and whether the project is reasonably certain to be completed within the first six months that new base rates will be in effect. The ALJ found that since NFGD has not identified any specific projects in its post-test year claim, and has relied on mathematical calculations, it is not possible for NFGD to satisfy this criteria, even if its claim was for CWIP. (R.D. at 13-14).

The ALJ found that while the Company clearly identified these additions as non-revenue producing, no effort was made by the Company to determine whether any of the additions would be expense-reducing. The only testimony regarding whether these additions were expense reducing was provided by Ms. Brocato in her Rebuttal Testimony. The ALJ opined that this testimony proved unreliable, as brought out on cross-examination (R.D. at 16).

The ALJ determined that the law is clear that only plant which is used and useful in service to ratepayers is appropriately included in rate base in the establishment of rates. See, e.q., Barasch v. Pennsylvania Pub. Util. Comm'n, 516 Pa. 142, 532 A.2d 325 (1987), aff'd Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989). Based on this principle, continued that ALJ, the Commission has found that plant that is not providing service to customers should not be utilized in setting rates. However, ALJ Kashi noted that the Commission has discretion in applying the "used and useful" standard to include in rate base a utility's investment in plant that will not be placed in service until some time after the end of the test year.

See, e.g. Pennsylvania Pub. Util. Comm'n v. Pennsylvania-American Water Co., R-00922428, slip op. at 8 (April 21, 1993) ("PAWC 1993"). The ALJ continued that in Pennsylvania-American Water Company's last rate case, the Commission rejected a claim for a project that was not expected to be completed until three months after the end of the test year. PAWC 1993, slip op. at 6-9. The ALJ cited PAWC 1993 as follows:

The Respondent complains that the disallowance of its claim will penalize the Company. However, the ALJ determined, and we agree, that in view of the Company's nearly annual rate filings, to allow plant in rate base that is not "used and useful" would not be fair to the Company's customers.

The Respondent may be correct in its assertion that we have never adopted or approved the rate case frequency distinction proposed by the ALJ. This does not mean, however, that such a distinction may never be made, and in this proceeding we find that the frequency of the Company's rate filings is a significant consideration in assessing the impact of its CWIP claim on the customers. (R.D. at 17).

The ALJ found that similar to PAWC, NFGD has been filing rate cases on an almost annual basis. Thus, the ALJ found that the lag between the time plant is placed in service and the time it is recognized in rates is relatively small. The ALJ found specifically that, especially in such circumstances, there is no justification for including in rates amounts related to plant which does not yet provide service to customers.

The ALJ's disposition of the issue appears below:

For all the above reasons, NFGD's speculative, unsupported post-future test year claim for purported plant additions of $ 3,521,000, retirements of $ 877,000, and associated depreciation expense of $ 215,000, should be denied. Consequently, we will recommend that the Commission should exercise its discretion to deny the Company's claim. Tables appended to this Recommended

Decision will include the adjustment proposed by the OCA because it does not duplicate the $ 307,000 adjustment accepted by the company in its final claim. (R.D. at 17-18).

2. Exceptions

In its Exceptions, NFGD argued that the ALJ's reasoning that inclusion of these additions in rate base would violate the matching principle disregards several Commission decisions. See Green v. Pa. P.U.C., 81 Pa. Commonwealth Ct. 55, 473 A.2d 209, 214 (1984), aff'd, Barasch v. Pa. P.U.C., 507 Pa. 430, 490 A.2d 806 (1985); Pa. P.U.C. v. NFGDC, 67 Pa. P.U.C. 264, 271-274 (1988); Pa. P.U.C. v. Peoples Natural Gas Co., Docket No. R-832315, p. 16 (January 13, 1984); Pa. P.U.C. v. Philadelphia Suburban Water Co., 55 Pa. P.U.C. 407 (1976); Pa. P.U.C. v. Philadelphia Electric Co.-Gas Division, 54 Pa. P.U.C. 1 (1980). (NFGD Exceptions at 3-4). Specifically, NFGD argues that the matching principle is not violated if, as here, the plant additions do not increase or decrease. NFGD concludes that neither the ALJ nor the OCA provided any basis for reversing the above cited precedents. NFGD repeats that it is within the Commission's discretion to include, in rate base, amounts spent on plant that will be in service within six months after the future test year. (NFGD Exceptions at 4).

In its Reply Exceptions, the OCA contends that NFGD has misconstrued its position on this issue. The OCA states that precedent does support leaving to the Commission's discretion the allowance for non-revenue producing CWIP. The OCA insists, however, that precedent does not mandate that every claim for CWIP be allowed. The OCA continues that the Commission clearly has the discretion to allow or deny such CWIP claims.

[2] Upon consideration of the Exceptions and Reply Exceptions, we agree with the ALJ's resolution of this issue. We agree with the OCA that we have the discretion to allow or deny the CWIP claim before us. Our careful consideration of the issue before us leads us to the conclusion that the Company's argument does not rise to the level that would counsel in favor of adoption of its CWIP claim. Accordingly, we deny NFGD's Exception and adopt the reasoning and recommendation of the ALJ.

B. Construction Work In Progress

Regarding the issue of Construction Work In Progress ("CWIP"), ALJ Kashi made the following disposition:

The OCA has proposed the elimination of NFGD's final claim for Construction Work in Progress ("CWIP") of $ 1,654,000, representing actual or projected construction expenditures through the end of the future test year, which will not be in service as of that date. The basis of the OCA's adjustment is that this CWIP is not "used and useful" and its inclusion in rate base creates intergenerational inequity. OCA M.B., pp 32-33.

Distribution did not respond to this proposal in either its main or reply briefs; therefore, the adjustment will be accepted in this Recommended Decision. (I.D. at 18)

In its Exceptions, NFGD argues that the ALJ, in adopting the OCA position that such CWIP is not used and useful and further, creates an intergenerational inequity, incorrectly stated that the Company did not respond to these arguments. Specifically, the Company disputes the OCA argument that an intergenerational inequity exists because for a brief time after the rates become effective, ratepayers would pay for CWIP that is not yet in service.

NFGD continues that the Commission and the appellate courts have determined that the Commission has the discretion to include in base rates, plant that will be completed within nine months of the future test year. NFGD submits that the cases cited in its Exceptions relating to non-revenue producing plant not in service within six months of the end of the test year, discussed previously, support that proposition.

NFGD submits that the ALJ also disregarded the fact that there is no need to recognize throughput or revenue decreases after the future test year because there is no basis for concluding that any such increases will occur. The Company continues that residential and commercial usage continues to decline as a result of customer conservation. Similarly, according to NFGD, there is no reason to believe that reductions in expenses will occur while rates in this proceeding are in effect. Furthermore, NFGD avers that its expenses have increased steadily from year-to-year, and that there will be no increases in revenues or decreases in expenses to offset the revenue requirement associated with plant additions. (NFGD Exceptions at 4-5).

NFGD criticizes the ALJ's reasoning that the Company's claim for projected post test year additions were based upon mathematical extrapolations which use historical construction rates and construction budgets, rather than identifying specific projects. Adoption of the ALJ's objection, argues NFGD, would result in the virtual preclusion of gas distribution companies from meeting the burden of justifying inclusion of post future test year projects in rate base. NFGD contends that its construction program involves numerous small projects completed over a relatively short period of time. NFGD characterizes the requirement to track such projects as unrealistic. Further, NFGD asserts that such a requirement is particularly unrealistic when compared to prolonged, substantial individual projects such as water treatment plants and electric generating stations.

NFGD argues that the ALJ's reliance on Section 1315 of the Code, is erroneous. The Company argues that this particular section of the Code applies only to electric utilities because it contains an exception for non-revenue producing and non-expense reducing investments which improve safety. The Company contends that its construction program consists primarily of pipe replacement, which is conducted based upon leak surveys. NFGD contends that pipes which leak are safety hazards due to the risk of explosions. Therefore, concludes NFGD, even if Section 1315 of the Code can be construed to apply to gas companies, it would present no bar to inclusion of the claim in rate base of the Company's post future test year plant additions.

In its Exceptions, the OTS requests a correction to the depreciation expense adjustment shown as $ 215,000 in Table II of the R.D. The OTS submits that the number should be reduced to $ 197,098. The OTS points out that the $ 215,000 depreciation expense adjustment is based upon a recommended disallowance of the Company's originally filed $ 3,972,485, net post test year plant addition claim. The OTS continues that the Company conceded $ 307,000 of the $ 3,972,485 as being revenue-producing. Further, the OTS points out that the tables attached to the R.D. (Specifically, Table II) are based upon the Company's revised rate base claim rather than the original claim. Therefore, the OTS submits that the proper depreciation expense disallowance is $ 17,056 less than that calculated in the R.D., or $ 197,098, because the $ 17,056 is the depreciation expense associated with the Company's conceded $ 307,000 post-test year plant reduction (OTS Ex. p. 3).

Since Table II of the R.D. reflects a post-future test year plant in service adjustment of $ 3,521,000, the OTS states that rather than the $ 3,972,485 as recommended by Mr. Gruber, further explanation is required. According to the OTS, the difference between the Company's original post-future test year plant in service claim of $ 3,972,485 and the Company's $ 307,000 rebuttal adjustment, is $ 3,665,485. However, $ 145,000 of the $ 3,665,485 is estimated non-revenue producing unidentified CWIP purported by the Company to be completed by May 31, 1995. The OTS states that since this $ 145,000 is included in the $ 1,654,000 CWIP adjustment discussed previously and included in Table II, this $ 145,000 must be netted out of the post-future test year plant addition adjustment to avoid double-counting. Thus, concludes the OTS, the test year plant adjustment is shown as $ 3,521,000. (OTS Exceptions at 4-5).

In its Reply Exceptions, the OCA counters the argument of NFGD regarding specific identification of projects. The OCA states that the Company failed to present any evidence on these points, and its

Exception is not based upon evidence of record. Specifically, the OCA asserts that no Company witness contended that it was unrealistic to specify the projects included in its post-test year claim. (OCA Exceptions at 3).

The OCA addresses NFGD's criticism of the ALJ recommendation concerning Section 1315 and the Commission's decision in PAWC.

With respect to the Company's dispute of the ALJ's reliance upon Section 1315 of the Code, and the Commission's decision in PAWC, supra the OCA states that NFGD attempts to distinguish PAWC from this case on the basis that the PAWC claim dealt with a single plant addition which was delayed beyond the future test year, creating uncertainty regarding the in service date. According to the OCA, the PAWC addition was relatively more certain than the NFGD additions which have not even been identified. (OCA Exceptions at 4).

[3] Upon our consideration of the issue before us, we shall adopt the recommendation of ALJ Kashi. We agree with the ALJ's reasoning. However, we adopt the ALJ's recommendation as modified by the OTS Exceptions. As in the previous issue, we are of the opinion that the Company did not meet its burden of proof regarding this issue, specifically in its failure to identify the specific projects. We find the argument contained in the Company's Exceptions to be unconvincing. Accordingly, we will grant the OTS Exception and deny the NFGD Exception.

C. Working Capital

1. Materials and Supplies

NFGD's balance of materials and supplies is set forth in Exhibit No. 108-C, in the amount of $ 1,858,000. The ALJ noted that no party has raised any issue with regard to materials and supplies, and the amount of $ 1,858,000 is reflected on page 7 of the tables appended to its Main Brief. The ALJ recommended that this amount should be accepted and included in rate base. No party has excepted to the ALJ's recommendation, therefore we will adopt the ALJ's recommendation as our disposition of the issue.

2. Prepayments

[4] NFGD's average prepayment balance is provided on Exhibit No. 108-C, p. 1. The balance is $ 428,000. Prepayment balances include the Commission's assessment, unamortized insurance premiums and American Gas Association dues. Of the total amount of $ 428,000, $ 170,000 is for the Commission's assessment, $ 244,000 is for unamortized insurance premiums, and $ 14,000 is for American Gas Association dues. Kenneth C. Springirth was the only Complainant who raised issues with regard to the foregoing prepayments. Mr. Springirth criticizes NFGD's payment of AGA dues (KCS Statement No.1.). The ALJ rejected Mr. Springirth's criticisms, reasoning that the AGA activities benefit Distributions ratepayers. See, NFGD M.B. at 199. The ALJ recommended that the average balance of $ 428,000 should be included in rate base. No exceptions were filed to the ALJ's findings and recommendation on this issue. Accordingly, we shall adopt ALJ Kashi's recommendation as our own action.

3. Gas Storage Inventory

Distribution's working capital requirement claim for gas in storage was updated in rebuttal testimony, and the final amount is $ 4,014,485. NFGD Stmt. 215, p.2; NFGD EX. 215-A; NFGD M.B. at 15. The Company argues that this working capital requirement is appropriate and should be adopted.

The Company initially proposed to include in rate base $ 4,183,378 for working capital related to underground gas in storage. NFGD St. 15 at 3; NFGD Exh. 108-C-3. Company witness Smycznyski testified that this amount was computed based on an estimated average inventory cost of $ .8052 per Mcf at September 30, 1994. (Id at 4). He testified that this reflects the average inventory rate at September 30, 1993, which reflects the purchase of gas in place from Supply effective August 1, 1993, at Supply's cost of its top gas in storage (Id). September 30 was used because it reflects the end of Distribution's fiscal year. Mr. Smyczynski then computed an average volumetric quantity of storage gas for a thirteen month period to calculate the working capital amount of storage gas of $ 4,183,878. (Id). While the OTS accepts the company's working capital claim for gas in storage, OCA strongly disagrees with Mr. Smyczynski's position.

The OCA has two disagreements with the NFGD proposal. First, Mr. Cotton, in challenging the initial claim, updated the inventory price and amounts in inventory and these adjustments are reflected on Mr. Cotton's Schedule 5. OCA St. 3 at 22 & Sch. 5. He utilized the actual average price of gas in inventory for the 13-month period shown on NFGD Exhibit, 108, page 2, of $ 0.7839/Mcf. (Id.) This resulted in an indicated storage gas in inventory of $ 3,413,582, resulting in an adjustment of $ 770,418. (R.D. at 20).

Next, the OCA argues that this Commission has consistently held that a 13-month average balance of working capital for gas in inventory is appropriate in establishing rates. See, e.g., Pennsylvania Pub. Util. Comm'n v. Philadelphia Elec. Co., 66 Pa. PUC 60, 66-69, 93 PUR 4th 12 (1988) ["PECO"]. In the PECO case, asserts the OCA, the Commission specifically rejected the Company's proposal to utilize a 12-month average based on an estimated cost of gas. In support of its position NFGD proffers the following cite from PECO: We concur with the recommendation of the ALJ that we adhere to the use of the thirteen month average balances based upon actual volumes and actual price for the future test year for determining the appropriate gas storage inventory claim. PECO has utilized a future test year in this proceeding, and we find it inappropriate to further adjust the thirteen month balances to reflect estimates of volumetric and cost changes for gas storage inventories. R.D. at 21-22

Moreover, argues the OCA, Company witness Smyczynski has failed to demonstrate that utilizing a 13-month average does not eliminate the seasonality associated with storage balances. The OCA submits that is the whole purpose of utilizing a 13-month average. OCA M.B. 35. In revised Schedule 5, Mr. Cotton reflects the 13-month average through May, 1994, which reflects a final claim of $ 3,596,283, and an adjustment to rate base of $ 587,717. It concludes that its position on this matter should be adopted as consistent with Commission practice.

The Company argues that OCA submitted no testimony or exhibits in response to Distribution's final claim for gas in storage. The ALJ observed that the OTS concurs with the NFGD working capital claim for gas in storage. (R.D. at 22; Footnote 3).

The ALJ observed further that in its brief, OCA submitted a new calculation of its adjustment to gas in storage. In performing its calculation, OCA maintains that a thirteen month average is to be used, and that the monthly storage balances are to be calculated at an inventory rate of $ .7839/Mcf. OCA contends that its calculation was undertaken in accordance with the Commission's PECO decision. OCA proposes a gas in storage working capital amount of $ 3,596,283. (Id).

The ALJ found that the primary difference between NFGD and OCA concerns the use of a 12-month versus a 13-month average for computing the average storage balance. In PECO, supra, the utility claimed a gas storage inventory balance based upon a normalized level of monthly inventory balances. The ALJ continued that in PECO, the Commission rejected the approach and adopted OTS' calculation of a 13-month average using actual storage volumes available for the future test year and estimated storage balances through the end of the future test year.

The ALJ concluded that although the record contains the data necessary to compute a 13-month gas storage inventory balance for Distribution for the 13 months ended November, 1994, in accordance with PECO (actual data from November, 1993 through June, 1994 and projected data from July through November, 1994), the OCA disregarded this data. Instead, found the ALJ, the OCA, in its brief, calculated a 13-month average ended May, 1994 n6 using actual data from September, 1993 through May, 1994, and hypothetical data for May, 1993 through August, 1993. n7 By using non-current data in its calculation, and ending its 13-month calculation in a low storage balance month, the OCA achieved an artificially low gas inventory balance. (R.D. at 23-24).

The ALJ continued that if, as OCA suggests, a 13-month balance is to be used, per the PECO decision, the gas storage inventory to be included in rate base, calculated at a $ .8052/Mcf average inventory rate, would be $ 4,210,312, as shown below:

** See Table in Original. **

(I.D. at 24; Footnotes Omitted.)

The ALJ noted that NFGD points out that this rate base amount, $ 4,210,312, based upon a 13-month average ended November, 1994, is virtually identical to the balance that would result using a 13-month average ended September, 1994, of $ 4,231,382. The ALJ noted that NFGD presented the calculation of a 13-month average ended September in rebuttal because it included all available actual monthly storage balances (September 1993-June 1994) and updated projections for the remaining months (July 1994-September 1994). According to ALJ Kashi, this calculation, using the greatest amount of actual data, confirms the accuracy of the 13-month average ended November 1994. Therefore, the ALJ concluded that if the Commission were to decide that a thirteen-month average should be used, the correct gas in storage inventory should be $ 4,210,312.

The ALJ found the OCA position on this issue unconvincing. While the OCA disputed NFGD's use of an average inventory cost of $ .8052/Mcf, it did not specify its reason for objecting to this cost. The ALJ found that NFGD's calculations are based upon the average storage inventory cost to be effective October 1, 1994, two months prior to the end of the future test year. The ALJ noted that NFGD calculated that average cost based upon the actual average cost of $ .7839/Mcf for 8,357,430 Mcf in storage at September 30, 1994, plus the additional actual purchase of 130,171 Mcf in October, 1994 at a cost of $ 2.171/Mcf (Ex. No. 215-A, p.2). Therefore, ALJ Kashi determined that it would be erroneous to contend that the average cost of $ .8052/Mcf is not a future test year cost. Consequently, objections to the use of the average inventory cost of $ .8052/Mcf were rejected. n8 The ALJ concluded that this cost is a readily determinable amount. The ALJ pointed out that as shown on Exhibit No. 215-A, p. 2, NFGD purchased 8,357,430 Mcf of gas in place at an average inventory cost of $ .7839/Mcf (St. No. 15, p. 4). In addition, NFGD purchased 130,171 Mcf for storage injection in October, 1993 at an average inventory cost of $ 2.171/Mcf. These purchases, when averaged, produce an average inventory cost of $ .8052/Mcf (Ex. No. 215-A, p. 2). This rate was then used by Distribution to value the monthly balances of gas in storage. (R.D. at 25-26).

[5] ALJ Kashi viewed gas in storage as a recent working capital requirement for NFGD, arising as a result of the transfer of the gas storage function from NFG Supply ("NFGS") to NFGD. This is as a result of the restructuring of pipeline services under FERC Order No. 636 (St. No. 15, pp. 3-4). The ALJ found that NFGD's final working capital claim for gas in storage reflects actual volumes of gas in storage for the ten months ended June 30, 1994 and two months of projected volumes of gas in storage. n9

The ALJ continued that NFGD's final working capital calculation for gas in storage is based upon average volumes for a twelve-month period, rather than the thirteen-month period traditionally used for other inventory working capital claims. n10 The ALJ noted that as NFGD's witness, Mr. Smyczynski, explained, gas storage balances are strongly affected by the seasons of the year (St. No. 215, p. 2). Thus the ALJ found that the gas storage balance as of the end of September (near the end of the storage injection period) will be substantially greater than the gas storage balance as of the end of March (near the end of the storage withdrawal period). As a result, found the ALJ, a thirteen month average ended September would produce a substantially different result than a thirteen month average ended in March, even if storage injection and withdrawal patterns were precisely the same on a monthly basis throughout the year. Thus, the ALJ concluded that a twelve-month average gas in storage balance be used. n11

Accordingly, ALJ Kashi recommended adoption of the recalculation of the company's claim as presented by NFGD witness James Smyczynski, using 10 months actual data through June 1994 and two months projected data (July-August), for a twelve month average claim of $ 4,014,485, as included in NFGD's final claim. (R.D. at 26-27).

Exceptions

In its Exceptions, the OCA cites Pa. P.U.C. v. Philadelphia Electric Company, 66 Pa. PUC 60, 66-69, 93 PUR 4th 12 (1988), ("PECO 1988") for the proposition that a 13-month average balance of working capital for gas in inventory is appropriate in establishing rates. The OCA continues that in

PECO 1988, the Commission specifically rejected PECO's proposal to utilize a 12-month average based on an estimated cost of gas. The OCA proffers the following cite from PECO 1988: We concur with the recommendation of the ALJ that we adhere to the use of the thirteen month average balances based upon actual volumes and actual price for future test year for determining the appropriate gas storage inventory claim. PECO has utilized a future test year in this proceeding, and we find it inappropriate to further adjust the thirteen month balances to reflect estimates of volumetric and cost changes for gas storage inventories. (Emphasis in original). (OCA Exceptions at 5).

The OCA argues that, contrary to the ALJ's assertions, its adjustment is very clearly intended to adhere to the Commission's PECO 1988 decision wherein the use of 13-month actual volumes and actual prices was required in establishing the level of storage working capital for the future test year. (Id.)

The OCA excepts to what it views as the ALJ's apparent acceptance of the Company's claim that it was not engaged in storage activities until September 1993, and thus its storage activities would be understated if data prior to that date were utilized. According to the OCA, these arguments were not presented until the Company's Main Brief. Furthermore, the OCA claims that it had not had a previous opportunity to respond to those arguments. (OCA Exceptions at 5-6).

The OCA concedes that NFGD's storage activity was somewhat lower prior to September 1993 than in subsequent periods. However, the OCA argues that this is not a sufficient reason to change the accepted practice of using 13-month averages. It is the opinion of the OCA that fluctuations in price and inventory balance can normally be expected from year-to-year, but that does not justify changing a methodology which is designed to even out those swings. The OCA strongly disagrees with the Company's argument that the seasonality of storage gas balances justifies its approach over OCA's proposal. The OCA continues that a 13-month average is designed to balance out seasonal fluctuations and should be utilized precisely to deal with this concern. (OCA Exceptions at 6).

Finally, the OCA points out that the ALJ noted that its schedules reflect data only through May 1994, and no data for June 1994, that was available at the close of the record. The OCA concludes that it does not object to updating the data through June, 1994. The OCA urges that its adjustment, which is based upon the actual 13-month averages of storage gas balances and prices be adopted. (Id.).

In its Reply Exceptions NFGD argues that if PECO 1988, which was relied upon by the OCA, were strictly applied an average balance greater than that presented by NFGD would be required in rate base. NFGD continued that in

PECO 1988, the Commission applied a 13-month average of storage balances at the end of the future test year. NFGD calculated that if one used the

PECO 1988 formula, then the average gas inventory would be $ 4,210,312, instead of $ 4,014,485, as claimed by NFGD. (NFGD Reply Ex. at 1-2).

NFGD notes that the difference between the amount computed under PECO 1988 and the figure proposed by the OCA results from what the Company views as a distortion caused by the choices of the initial, and therefore, ending months for the 13-month averages. According to NFGD, a starting date for a 13-month calculation, beginning in February or March, will always produce a much lower average than the 13-month average beginning in October or November due to the storage injection/withdrawal cycle. NFGD offers as an example, a 13-month average beginning in March double counts a monthly balance of approximately $ 500,000, in the Spring when storage is depleted as a result of Winter use. In contrast, NFGD submits that a 13-month average beginning in November, when storage is full in preparation for the winter, a monthly balance of nearly $ 6.8 million is double counted. Thus, concludes the Company the choice of a starting month can produce a swing of nearly $ 500,000. (NFGD Reply Ex. at 2).

Based upon the foregoing discussion NFGD repeats that it has presented its gas in storage inventory based on a 12-month average to avoid issues on the choice of a future test year that can arise where a 13-month average is used for gas inventory. NFGD urges that the Commission adopt its proposal which was adopted by the ALJ. (Id.).

Upon our careful consideration of the Exceptions and Reply Exceptions, we agree with the ALJ's decision to adopt the NFGD analysis and base its working capital allowance of 10 months of actual data and two months of projected data. We find that the OCA's Exceptions do not give us sufficient basis for overturning the ALJ's recommendation on this issue. Accordingly, we will adopt the recommendation of the ALJ, and deny the OCA's Exception.

4. Cash Working Capital

No party raised any cash working capital issue. The amount of $ 14,754,000 was reflected in NFGD's rate base, subject to adjustments based upon changes in levels of expenses by this Commission. R.D., p. 29.

5. IRS Audit Assessment

The Internal Revenue Service ("IRS") has notified NFGD of tax deficiencies with regard to tax years 1977-1986. A portion of such tax deficiency relates to IRS' conclusion that amounts received by NFGD during this period from customers for installation of service lines constituted taxable income to NFGD.

The ALJ points out that prior to the adoption of the Tax Reform Act of 1986, NFGD and other utilities considered amounts received from customers for construction of utility facilities to be contributions in aid of construction that were exempt from taxation under Section 118 of the Internal Revenue Code. The ALJ continued that as part of the Tax Reform Act of 1986 ("TRA-86"), the Internal Revenue Code was amended to provide that such payments by customers to construct facilities were taxable to the utility. Pursuant to TRA-86, property financed with the payment became part of the depreciable assets for tax purposes thereby increasing tax deductions over the tax life of the property (St. No. 16, p. 9).

At the request of OTS, the Commission initiated an investigation at I-880083 to determine the appropriate ratemaking treatment of such increased taxes. By Order adopted May 11, 1989, at I-880083, the Commission determined that gas and electric utilities should include in rate base the tax that is paid by the utility as a result of receipt of the contribution. As the tax depreciation on plant constructed with a contribution is received, the rate base reduction is removed (Order of May 11, 1989, at I-880083, pp. 3 and 24).

The IRS tax assessment makes contributions received from customers for service lines during tax years 1977 to 1986 taxable income. Consistent with the Commission's determination at I-880083, NFGD has included in rate base in this proceeding the portion of taxes on such service line contributions that will not have been recouped through increased tax depreciation by the end of the future test period in this proceeding.

OCA contends that this rate base adjustment is somehow retroactive ratemaking. The ALJ included the following colloquy from the record which occurred when the OCA's witness was asked to explain this theory:

Q. How does retroactive ratemaking preclude the remaining balance of that tax from being included in the rate base in this proceeding?

A. Well, I think what you're trying to do is to change the rate base in this proceeding to reflect the fact that the treatment of contributions changed in the past.

Q. But the point is that IRS will have said that is a taxable event, and that tax will remain paid by the company and un-recouped by the company through depreciation, will it not?

A. Yes, I agree with that.

Q. Is recovering a return on that on a prospective basis, in your opinion, retroactive ratemaking?

A. Well, I think when you say on a prospective basis, it's because there was a prior change.

Q. It's a prior change that affects rates from now forward. Is that retroactive ratemaking in your mind?

A. If it's due to the IRS audit changes, yes. If it's not due to the IRS audit changes, no. Maybe that answers your question. (R.D. at 32-33)

The ALJ was of the opinion that such explanation provided no rational basis for denying this rate base adjustment. The ALJ found that the IRS has determined that service line contributions were taxable, and that at the end of the future test year, $ 204,000 of taxes associated with such service line contributions will remain unrecovered through increased depreciation. The ALJ concluded that inclusion of such amount in rate base for determining rates on a prospective basis until such time as such tax is recovered through tax depreciation is prospective ratemaking and is consistent with the Commission's treatment of taxes on contributions subsequent to TRA-86. The ALJ commented that the OCA's contentions are without support and should be rejected. (R.D. at 33).

In its Exceptions, the OCA disagrees with the ALJ's conclusion that the Company's claim does not constitute retroactive ratemaking, and instead is prospective ratemaking and is consistent with the Commission's treatment of taxes on contributions subsequent to TRA-86. The OCA continued that since these taxes relate to contributions made during the period 1977-1986, it raises the question of how inclusion of these taxes in rate base would not constitute retroactive ratemaking. The OCA contends that in essence, NFGD is requesting and the ALJ has agreed to make a line-by-line examination of prior tax expense with respect to one item which is in clear violation of precedent prohibiting such retroactive ratemaking. See Cheltenham & Abington Sewerage Co. v. Pennsylvania Public Utility Commission, 344 Pa. 366, 25 A.2d 334 (1942), ("Cheltenham"); Barasch v. Pennsylvania Public Utility Commission, 507 Pa. 496, 491 A.2d 94 (1985), ("Barasch"). (OCA Exceptions at 7-8).

The OCA continues that in Barasch the Pennsylvania Supreme Court stated that "current ratepayers should shoulder only actual expenses of providing current utility service." Barasch at 507 Pa. 517, 491 A.2d at 104. Thus, it is the position of the OCA that NFGD's proposed inclusion of $ 204,000 in taxes related to the period 1977-1986 does not constitute a current expense necessary to provide current service. (OCA Exceptions at 8).

The OCA continues that this claim does not involve a change in tax law. According to the OCA, the deficiencies caused by the IRS audit adjustment for which NFGD requests recovery, were not incurred due to an unusual and nonrecurring occurrence. The OCA asserts that NFGD wants rate recovery for this deficiency to reward it for past aggressive tax positions that ultimately resulted in a penalty. (Id.)

The OCA cites the testimony of OTS witness Mr. Maher that because ratemaking calculations are hypothetical, based upon pro forma revenues and expenses normalized to a future test year level, the actual taxes allowed may be substantially different than the actual taxes due on a return. The OCA contends that here, NFGD seeks to retroactively fix a deficiency that occurred in a prior period due to its past tax practices through current recovery. It is the position of the OCA that this is improper and should be permitted. (OCA Exceptions at 8-9).

Finally, the OCA points out that the Company has appealed the IRS audit decision. Thus, points out the OCA, the extent of the Company's tax liability to the IRS is now not known and measurable. Therefore, the OCA suggests that in the alternative, the claim should not be recovered at this time since it is speculative. (OCA Exceptions at 9).

In its Reply Exceptions, NFGD notes that its appeal to the IRS is expected to be resolved by the years' end. NFGD continues that it is highly unlikely that the Revenue Agent's Report would be reversed. (NFGD Reply Exceptions at 4).

[6, 7] Upon consideration of the issue, we will not adopt the ALJ's recommendation which would allow the Company to recover the portion of taxes on such service line contributions that will not have been recouped through increased tax depreciation by the end of the future test period in this proceeding. As noted previously, the Company has appealed the IRS ruling, and therefore the results of the ruling are not final, so therefore the request to recover the associated expenses remain speculative.

We support the Company's position on appeal and fully expect that NFGD will prevail on the merits of the claim. We hasten to add that our disallowance of the claim is without prejudice to future recovery of the expense in the unlikely event that the Company's appeal is unsuccessful. Based upon the foregoing discussion, the OCA's Exception is granted to the extent consistent with this Opinion and Order.

6. Customer Deposits

NFGD reduced its rate base to reflect customer deposits. NFGD M.B. Tables p. 7. The amount of the reduction was $ 555,000. See R.D., p. 34. No party raised an issue with respect to this reduction and we shall adopt the ALJ recommendation concerning same.

REVENUES

Weather Normalization-Degree Days

In this proceeding, NFGD states its opposition to its usual practice of using a 30-year average of historical annual degree-days to normalize the effects of temperature variation on throughput and revenues for ratemaking purposes. NFGD contends that the use of 30 years of data produces poor forecasts and results in the overstating of throughput and revenues. NFGD M.B., pp. 23-25. Citing various articles taken from meteorological journals, NFGD argues that there is no real scientific basis for the use of 30 years of data to establish climatic normals. NFGD argues that this standard was the result of a compromise among options which was reached at the 1933 convention of the International Meteorological Organization in Warsaw. According to NFGD, such normals are expressions of climatic conditions within the 30-year period, and cannot be used to predict conditions beyond that period. Id., pp. 42-44.

NFGD also contends that periods other than 30 years have been used in the past for weather normalization purposes in Pennsylvania and elsewhere. NFGD claim that in recent years there has been increased use of periods significantly shorter than 30 years in numerous jurisdictions. Id., pp.

49-50. The Company asserts that in its most recent base rate case, weather normalization was based on the average of the 30-year and the 10-year normals.

Id., p. 50.

Based on an article with regard to climatic conditions in the state of Illinois which concluded that 5- and 10-year normals have better predictive value than 30-year normals, NFGD performed its own statistical study of historical temperature data for the Erie, Pennsylvania Weather Service Office. From this study, NFGD concluded that the use of a 10-year period is more appropriate than a 30-year period for the determination of degree-day values for weather normalization purposes. Id., pp. 44-46. Thus, in this proceeding, NFGD has utilized the 10-year period from 1984 through 1993 to establish its figure for the normal number of annual degree-days, which it has determined to be 5,955. It is this number which NFG used to develop its forecasted sales volumes for the future test year. NFG St. No. 14, pp. 17-18.

The OTS opposes NFGD's use of the 10-year average instead of a 30-year average, arguing that the goal is not to predict weather but to derive a normal level of degree-days. OTS M.B., p. 23. The OTS contends that NFGD's use of only 10 years of data is not consistent with the National Oceanic and Atmospheric Administration's (NOAA) definition of "normal" as the arithmetic mean of a climatological element computed over a long time period. Id., pp. 23-24. The OTS further contends that "the Commission has historically used thirty years of data for revenue normalization purposes and has used thirty years of data for NFGD in all fully litigated cases, as indicated in interrogatory response OCA-8-9 (included as Appendix A to OCA Statement 3)." OTS R.B., p. 12.

With respect to the Company's reference to the use of a period other that 30 years for weather normalization in its most recent rate case, the OTS notes that the prior case was resolved through stipulation and not litigated.

Id. In this regard, the OTS objects to the Company's reference to this case, as set forth in the following:

OTS strenuously objects to NFGD's misuse of the settlement process in this manner. Parties will definitely be reluctant to settle cases and issues in the future, in contravention of Commission policy to encourage settlements, if utilities continue to use settlements against parties in future litigation of issues. See 52 Pa. Code §§ 5.231 and 5.224(f); 52 Pa. Code §§ 69.391-69.395.

Furthermore, the Stipulation concerning degree days which was entered into in the Company's last base rate case, specifically provides that the stipulation is made without any admission against, or prejudice to, any position which any party to the Stipulation may adopt during litigation of this proceeding following a disapproval by the Commission of this Stipulation and in any proceeding initiated after the Commissions's final order in this proceeding. Emphasis supplied.

See, Stipulation Concerning Degree Days To Be Used In Weather Normalization Of Sales Volumes And Revenues For Ratemaking Purposes, Docket No. R-00932548; approved by the Commission by Order entered December 1, 1992. The instant base rate proceeding was obviously instituted subsequent to the Commission's final Order in the last base rate case. NFGD should not be permitted to "prejudice" other parties' positions in this proceeding by referring to this prior degree day stipulation.

Id., pp. 12-13.

In place of the Company's 5,955 number, the OTS developed a figure of 6,193 as the appropriate number of annual degree-days to use for weather normalization, based on the most recent 30-year period of December 1, 1964 through November 30, 1993. The resulting revenue adjustment to reflect the difference between actual and normalized sales is $ 1,142,696 for residential revenues, and $ 111,986 for commercial revenues. Id., p. 24. The OTS asserts that its adjustment "is reasonable and should be adopted for the following reasons: (1) it is consistent with the NOAA definition of 'normal' in that it uses heating degree-day data over a thirty-year period, (2) it encompasses a length of time which is sufficient to smooth out short term aberrations of data, (3) it is based upon published and readily available source material and (4) a presentation of data based upon a period of time less than three decades is merely an 'average' and not a 'normal'." Id., p. 25.

The OCA is also opposed to NFGD's use of the 10-year average of degree-day data for weather normalization. Like the OTS, the OCA argues that the purpose of determining normal weather is not to predict the weather, but to determine what is normal or typical weather from year to year in the area in question. The ALJ found that it is the OCA's position that the 30-year average of data is the only common standard used for this purpose in utility regulation. OCA M.B., p. 37. The OCA contends that while one of the articles cited by NFGD concludes that 30 years of data is not optimum for predicting weather over the next few years, it is equivocal as to the preferable period to use in determining a normal. OCA R.B., pp. 15-17. The OCA contends that the articles cited by NFGD actually support the argument that a 30-year normal represents typical weather experience. OCA M.B., pp. 38-39.

With regard to the article concerning the analysis of Illinois data on which NFGD based its own study, the OCA asserts that the Company's reliance on this article is misplaced. The OCA argues that the credentials of the article's authors are unknown, and that the authors were not available for cross examination in this proceeding. OCA R.B., p. 13. The OCA further argues that NFGD's study was not as rigorous or otherwise comparable to the study detailed by the article. Id., pp. 13-15.

Finally, with respect to NFGD's reference to past rate cases, the OCA, like the OTS, objects to the Company's inclusion of settlements among these cases. In this regard, the OCA argues as follows: Those settlements clearly specified that the treatment of weather normalization of revenues in those cases was not to be construed to represent approval of any party's position on any issue. Nor was the methodology by which the degree days utilized in NFGD's last proceeding specified therein, but was the subject of confidential settlement discussions that were not memorialized in the settlement document, and should therefore have remained confidential. Pennsylvania Pub. Util. Comm'n v. National Fuel Gas Dist. Corp., R-932548, Stipulation Concerning Degree Days To Be Used In Weather Normalization Of Sales Volumes and Revenues For Ratemaking Purposes (May 26, 1993) ["Degree day Stipulation"]. Only the degree day number of 6,202 was shown in that settlement document, not the method used to reach it. That stipulation stated: It is expressly understood by the Parties that their joining in this Stipulation does not involve any agreement, either in this proceeding or in future proceedings, concerning the propriety of any specific methodolgy (sic) for determining a normal level of annual heating degree days. Therefore, Parties joining in this Stipulation will be permitted, despite this Stipulation, to advocate in future proceedings the use of any number of years of data to normalize volumes and revenues, and Distribution may in future proceedings proposed a **weather normalization clause.**

Degree Day Stipulation, P11.

Id., pp. 17-18.

For these reasons, the OCA advocates the continued use of the 30-year average of data for weather normalization. Based on this position, OCA utilized the NOAA 30-year normal degree-day figure of 6,279. OCA M.B., p. 36. The resulting revenue adjustment is an increase to present revenues of $ 2.199 million.

Id., p. 41.

The OSBA also objects to NFGD's use of 10 years of data to develop its degree-day figure. Like the OTS and the OCA, the OSBA criticizes the Company's reliance on the various climatological articles it cited. The OSBA asserts that none of these articles offers a definitive statement as to the appropriate climatic average to use, and none supports use of a 10-year average. The OSBA M.B., pp. 7-10. With respect to the article on which NFGD based its specific climatological study, OSBA states the following: While the authors found ten year normals to have a "high probability" of being the best predictors as suggested by the Company, the ten year period was not endorsed as providing the most frequent closest estimate of the next year's summer and winter mean temperature and precipitation. Yet, the authors acknowledged that "[t]hirty year normals tend to be the best predictors when the temperature departures are of intermediate size." The Illinois Situation, p. 1387. Once again, there was no definitive endorsement of a ten year period.

Id., p. 10.

Moreover, the OSBA questions the applicability of the results of the Illinois study to NFGD's service area in northwestern Pennsylvania. Id., pp. 10-11.

With respect to NFGD's reference to its previous base rate case, the OSBA, like the OTS and the OCA, sharply objects to such a reference because the case involved a stipulated degree-day number. The OSBA argues that "NFGD's discussion and apparent reliance on the alleged methodology used in reaching the stipulated degree-day value in the Company's prior rate proceeding is in direct contravention to the express language, understanding and agreement of the parties, including NFGD, to that stipulated settlement." OSBA R.B., pp. 5-6. Furthermore, the OSBA asserts that the parties to the stipulation agreed only on a degree-day number, not a specific methodology for determining it.

Id., p. 6.

Thus, with regard to the proper time period to consider in developing a degree-day forecast, the OSBA concludes as follows:

The Company's determination that a ten year normal should replace the well-established 30-year NOAA normal is inconclusive at best. Certainly, the Company has failed to present sufficient evidence in this case to support a change to a ten year period as opposed to any other time period, particularly the 30-year period used in prior litigated cases. As OSBA witness Edwards illustrated in his thorough testimony on the subject, there is evidence which is just as strong, if not stronger, to support the position that a period

greater than 30-years should be used to develop a normal degree-day value. OSBA M.B., p. 11.

In addition to its belief that NFGD used an improper time period, the OSBA also contends that the Company used incorrect data in developing its degree-day forecast. The OSBA argues that the Company incorrectly used a computational procedure which was developed by NOAA to estimate normal degree-days when a complete history is not available. However, the OSBA asserts, a complete history is available in this case. Id., p. 13. The OSBA also contends that NFGD improperly used data that had been adjusted by NOAA for reasons that were not entirely clear, but apparently had to do with allowing for comparisons of data across different weather stations. According to the OSBA, the purpose for these adjustments is not applicable in this case where the task is to determine the appropriate numbers to use for Erie International Airport for purposes of setting utility rates for NFGD. OSBA M.B., pp. 13-16; R.B, pp. 13, 26. Furthermore, the OSBA asserts that while NFGD witness Mark D. Pijacki used the adjusted data to determine a normal degree-day value, NFGD witness Joanne E. Zablonski used unadjusted data to perform sales and revenue forecasts. OSBA M.B., p. 15. Thus, the OSBA concludes that the Company's revenue projections are internally inconsistent.

Id., pp. 15-16.

In place of the Company's degree-day number of 5,955, the OSBA recommends a figure of 6,414. This figure was developed by OSBA witness Herbert J. Edwards through the use of statistical techniques known as Box-Jenkins analysis and Fourier regression. OSBA M.B., pp. 17-19; R.B., pp. 23-24. Mr. Edwards' analyses resulted in twelve different forecasts based on twelve different combinations of methodology and time frame. OSBA M.B., p. 19. Of these twelve forecasts, Mr. Edwards chose 6,414 degree-days as the most appropriate number to use in this case. The OSBA describes this choice as follows:

As Chart 11 of OSBA Stmt. No. 1, p. 41 indicates, the consensus of the data indicates a value generally at or about the 6,400 level, not the 5,900 suggested by the Company. The most straightforward approach - the use of a straight average - also suggested a number in the 6,400 range: specifically 6,414. Further, the average of the NOAA 30-year normal of 6,279 and the NOAA 30-year average actual of 6,513 also falls within the 6,400 range: specifically 6,396 degree-days. Since the straight 46 year average was consistent with his other forecasts and given that this source also permits the identification of monthly values (See, OSBA Ex. No. 1, Sch. 1, p. 2) which are also needed to support studies like forecasting analyses and weather-normalization of actual histories, 6,414 was adopted as Mr. Edwards' specific degree-day recommendation for this case. OSBA Stmt. No. 1, p. 43.

Id., p. 20.

The 46-year history used by OSBA witness Edwards represents the period from January 1948 to December 1993. OSBA R.B., p. 25. With regard to its analysis using 46 years of data, and the resulting degree-day number, the OSBA concludes as follows:

In this case, the available and reliable information spans a 46-year history. Last year, the number would have been 45 years, which was the period used in a 1983 Pennsylvania rate case involving Equitable Gas Company at Docket No. R-822123. When all is said and done, this time frame has at least one unquestionable advantage over the Company's preferred ten year history: It contains more than four times as many observations, which correspondingly reduce the potential for misleading results. The OSBA further believes that there is no magic involved in the selection of a particular time period. To the contrary, the OSBA believes that, once the decision is made to seek some alternative to the time-honored use of the NOAA normal, the selection of an appropriate time period should be based on sound analysis and good sense.

Only the OSBA has met this standard.

The OSBA's studies have produced a number of results based upon different combinations of time frame and technique. The results, not surprisingly, have covered a range of values which, as noted elsewhere, tend to fall both above and below 6,400. The ALJ and the Commission can take reassurance from such results, because they indicate that the use of the 46-year average of 6,414 reflects exactly the appropriate regulatory standard: Striking a reasonable balance between the interests of ratepayers and those of NFGD's investors.

Id., pp. 27-28.

The OSBA contends that because of NFGD's use of an improper degree-day figure, the Company has overstated its increase request in this proceeding by $ 2.4 million. OSBA M.B., p. 5. Therefore, the OSBA asserts that the Company's total requested increase in this case should be $ 13.5 million and not $ 15.9 million. OSBA St. No. 1, p. 52. The OSBA submits that should the Commission choose not to depart from the NOAA standard, then the NOAA 30-year normal of 6,279 would be the appropriate degree-day number to use for weather normalization. OSBA M.B., p. 21. This is the number advocated by the OCA.

In response, the Company criticizes the OSBA's analysis, arguing that its use of a 46-year history and unadjusted data does not take into account the inhomogeneity of such data due to changes in instrumentation over the years. NFG M.B., pp. 52-55. NFGD also criticizes the OSBA's use of the Fourier regression analysis. NFGD contends that use of this technique on raw data is not supported by meteorological or climatological literature, and produces impractical results. Id., pp. 55-56. With respect to the difference between the types of data used by NFGD witnesses Mr. Pijacki and Ms. Zablonski, NFG argues as follows: In summary, Distribution uses the annual NOAA-adjusted degree days where annual data are sufficient for its purposes. For actual revenue calculations, however, the adjusted data are not sufficient because they are computed only for calendar months. These data cannot be used for revenue calculations because they do not provide daily values. To make monthly consumption analyses, daily data are necessary so that temperature data can be matched to billing cycle data so that the temperature data are for the same period as consumption data.

Id., p. 56.

In general, with regard to the OSBA's position, NFGD concludes as follows:

Despite the sheer size and number of statistical exercises contained in OSBA's presentation, . . . it is seriously flawed. If OSBA's approach had been used in the last ten years, it would have overstated actual degree days in nine of the last ten years. There would have been a cumulative total overstatement of degree days of 4,106 offset by a single occurrence in which annual degree days exceeded its recommended normal by only 89 degree days.

Statistical analyses can be useful tools in analyzing data. They cannot be used, however, without an occasional reality check. OSBA's recommendation fails this check and should be rejected.

Id., p. 58.

With regard to this issue, ALJ Kashi concluded as follows:

After a careful evaluation of the positions of the parties as presented above, we must conclude that the Company's use of a degree-day figure based on a 10-year average of data is not appropriate. Support for the Company's study is weak with regard to methodology and data, based as it is upon a single article which does not relate to NFG's service territory, and which does not appear to have wide support or use for ratemaking within the utility industry. Also, as OSBA argues, the use of only 10 years of data as opposed to a larger sample is questionable, and likely to produce inaccurate results with regard to normal weather. Nor is the Company's proposal supported by the other articles cited in this case, whose conclusions appear to be ambiguous with regard to the proper number of years to use in determining a normal number of degree-days for ratemaking purposes. For these reasons we are reluctant to depart from the use of the 30-year standard as advocated by OTS and OCA.

With regard to OSBA's proposal, although it is based on a larger sample of data and an apparently more sophisticated statistical analysis, we find no compelling reason to favor it over the more well-established use of a 30-year normal. Therefore, we recommend that the NOAA 30-year normal degree-day number of 6,279 be used for weather normalization in this proceeding. This is the figure proposed by OCA, and supported by OSBA as an alternative to its primary position. According to OCA, use of 6,279 degree-days will result in an adjustment of $ 2,199,032 to NFG's present revenues. OCA St. No. 3, p. 23. (R.D. at 46-47).

The ALJ also proffered the following remarks prior to concluding his discussion of the issue: Before leaving this issue, we will address the matter of NFG's reference to its most recent base rate case at Docket No. R-932548 in support of its position in this case. As the other parties in this case have pointed out, the issue of degree-days for weather normalization was resolved in a stipulation in that proceeding. The stipulation specified a degree-day number, but did not specify a methodology to use in its development. Thus, as OTS, OCA, and OSBA argue, it is not appropriate for NFG to assert that its proposed methodology in this case was adopted in the prior rate case. Such an assertion violates the language and spirit of the stipulation. As the other parties argue, this use of the stipulation does damage to the settlement process because it tends to create an atmosphere of distrust and a reluctance among parties to enter into settlements in future proceedings. This is contrary to the Commission's policy of encouraging settlements of rate proceedings whenever possible. Therefore, we recommend that NFG be directed to refrain from making any future references to settlement agreements that involve inaccurate claims or reveal information that was meant to remain confidential, or is otherwise irrelevant to the proceeding in question. (R.D. at 47-48).

In its Exceptions NFGD proffers a schedule which, in its view illustrates, that the use of 30 years of data has failed to produce realistic or fair results for more than a decade. (NFGD Exceptions at 8). NFGD continues that the ALJ's recommendation, if applied to the period set forth in the said schedule, would produce an annual average overstatement of revenues actually recovered of approximately $ 1.8 million. Thus, argues NFGD, it is clearly shown that recurring annual accuracies of this magnitude cause a significant underrecovery of the cost of providing service to heat-sensitive customers. The use of 10 years of data to normalize revenues according to NFGD is more responsive to recent and current weather conditions. (NFGD Exceptions at 8-9).

NFGD repeats that it conducted a study of scientific literature which it claims supports its position that the use of 30 years of data produces poor forecasts. NFGD continues that 30 year periods are only intended to define normal, only with other 30-year periods. (NFGD Exceptions at 9).

NFGD also repeated the results of the temperatures as reported by the Erie Weather Service Office. According to NFGD, the results of that study demonstrated that a 10-year period is the best prediction of future degree day values in its service territory. NFGD proffered the testimony of the OTS witness in which, in the Company's view, the witness agrees that a 10-year period appears to be a better predictor of degree day tendencies. Additionally, NFGD submits that the OCA witness agreed with that view. (NFGD Exceptions at 9-10).

The Company concluded that contrary to the ALJ's interpretation, of the scientific material, the said material uniformly condemns the use of 30 years of data to establish normal temperatures. The Company repeats that its own statistical studies of degree days at the Erie Weather Service Office demonstrated that the use of 10 years of data was optimal. (NFGS Exceptions at 10).

In its Reply Exceptions, the OCA referenced arguments advanced in its Main and Reply Briefs, that the Illinois study, relied upon by the Company, did not attempt to address the applicability of 30-year normals in other jurisdictions. The OCA continued that the 30 year model proffered by NFGD in its Exceptions is limited to a single period, and is not as comprehensive as the study sponsored by the OCA. (OCA Exceptions at 5-6).

The OCA acknowledges a wide range of opinions regarding the appropriate base for normalizing revenues in a rate proceeding. The OCA continues that the company's approach has as its objective the prediction of weather during the period that the rates will be in effect. However, the OCA maintains that the objective of weather normalization for ratemaking purposes is to determine what is typically experienced in the area where service is provided from year to year. In this regard, continues the OCA, the impact of weather on revenues is little different from other factors weighing on other revenue and expense items. For such items, says the OCA, while it may be possible to predict the expenditure or revenue change, the preference in setting rates is to utilize the normal, or typical level, absent a known and measurable change in the data. For that purpose, the OCA submits that the 30-year NOAA study serves well and the ALJ's recommendation for its continued use should be followed. (OCA Reply Exceptions at 6-7).

The OTS in its Reply Exceptions, re-emphasizes that while NFGD alleges that according to the statistical analysis the ten year average is a more accurate predictor of future weather, the goal of revenue normalization is to predict a normal level of degree days. The OTS reiterated that the 30-year NOAA study has been historically relied upon for weather normalization purposes. The OTS concludes that the 10-year normalization period proposed by NFGD is inconsistent with the NOAA definition of normal which requires computations over a long time period. (OTS Reply Exceptions at 7).

[8] Upon our consideration of the positions of the parties, we reject the proposal of NFGD to adopt a 10-year period of degree day data for revenue weather normalization. We agree with the OCA and the OTS that the Company has not provided sufficient support for its proposal for us to

abandon the recognized standard of 30 years of data.

Insofar as a numerical adjustment, we find most reasonable, the proposal of the OTS, discussed, supra, herein, and at pages 36-38 of the Recommended Decision. The specific adjustment proposed by the OTS utilizes 30 years of data for degree day computation, and arrives at an average degree day total of 6,193 as opposed to the average of 5,955 for the Company and 6,279 for the OCA. Thus the total OTS adjustment between actual and normalized sales is $ 1,142,696, for residential revenues, and $ 111,986 for commercial revenues, or $ 1,254,682. Our adoption of the OTS adjustment in lieu of the ALJ's adjustment of $ 2,199,032, will result in a reduction to the expense adjustment of $ 944,350. Accordingly, the allowable revenues will increase by the same amount. Based upon the foregoing, the ALJ's recommendation is adopted insofar as it rejects the proposal to establish a 10-year period of data collection and study for weather revenue normalization and rejected regarding the adoption of the OCA calculation of the dollar value of the adjustment.

Weather Normalization Clause

In this proceeding, NFGD is proposing to establish a **Weather Normalization Clause** ("WNC") which would be applicable to the rates of all weather sensitive customers, and would essentially eliminate the effect of temperature fluctuations on the Company's ability to recover non-gas cost revenues. As NFGD explains, the Company recovers the majority of its non-gas costs through commodity rates applied to the volume of gas sold and transported. For heat sensitive customers (mainly residential, commercial and public authority classes), these rates are based on pro forma sales and revenues which, in turn, are based on the determination of a "normal" number of degree-days. NFG M.B., pp. 26-28. According to the Company, if the actual experienced number of degree-days differs from the determined normal, experienced sales will vary from the pro forma amount. The Company argues that its recovery of fixed costs (the majority of non-gas costs) will be affected by any fluctuations from the normal number of degree days since these costs do not vary with usage.

Id., pp. 28-29. As NFGD explains:

If weather is warmer than "normal," recovery of such fixed costs is less than actual fixed costs and a portion of amounts intended as an allowance for return on investment must be used to pay these fixed expense. If weather is colder than "normal," more than fixed expenses are recovered and return is enhanced. The result is that Distribution either overearns or underearns its allowed return, due to a factor, weather, which is outside Distribution's control.

Id., p. 29.

NFGD claims that it has experienced substantial average annual margin revenue shortfalls during the period between 1983 and 1993 due to this weather factor.

Id. NFGD argues that the weather normalization process as it now stands only addresses one-half of the problem of the effects of weather on revenue recovery. That is, weather normalization attempts to remove temperature as a distorting influence on the level of revenues to be allowed in the ratemaking process, but does not remove it as a distorting influence on the level of revenues actually recovered. Thus, NFGD proposes to establish the WNC as "the next logical and reasonable step to correct the continued failure of the weather normalization process to adjust for temperature variations."

Id., p. 34.

NFGD describes the operation of the WNC as follows:

The WNC adjusts the rate per Mcf based upon the difference between actual heating load and weather-normalized heating load, calculated in accordance with the procedure used to derive normalized load for ratemaking purposes (St. No. 14, pp. 25-27). The WNC would be applied during all billing cycles, except the June, July, August and September billing cycles, when there is virtually no heating load. The WNC computes the amount of the adjustment by setting forth the applicable monthly degree day factors for residential and for commercial/public authority customers and by identifying, separately, average non-heating or "base" loads for the residential and for the commercial/public authority rate classes.

Id., p. 30, footnote omitted.

According to NFGD, the formula used to derive the monthly weather adjustment that would be applied to each residential, commercial and public authority customer's monthly bill during the 8 months of the year when there is a significant heating load, is as follows: delim @@ gfont 1 gsize 8 WA=(R x DDF (NDD - ADD)) over (BL + (DDF x ADD)) where R is the tailblock non-gas cost margin for the customer's rate class, BL is the average non-heating or "base-load" for the customer class, DDF is the degree day factor, stated as Mcf used per degree day, NDD is normal degree days for the billing period and ADD is actual degree days for the billing period. The R, BL, DDF and NDD components are all established as part of the ratemaking process. The ADD component will be provided by the National Oceanic and Atmospheric Administration.

Id., p. 31, footnote 21.

NFGD asserts that the WNC will stabilize revenue recovery and customer bills, but will not increase or enhance its revenues for recovery of non-gas costs above the level allowed by the Commission. Id., p. 31. NFGD further asserts that the WNC will not adjust bills to account for load lost due to non-temperature factors such as customer conservation, loss of customers, or changes in expense levels. Id., p. 32.

NFGD notes that WNCs have already been established by utility companies in other jurisdictions, including NFG in New York. Id., p. 35. NFGD witness Mark D. Pijacki provided an extensive list of such companies in his direct testimony. NFGD St. No. 14, pp. 31-32.

In conclusion, NFGD presents the following argument:

Although the WNC does not provide a complete solution to the problems of determining "normal" temperatures for a future period when rates will be in effect, it does reduce significantly the importance of degree day controversies. As explained by Mr. Pijacki: Another significant benefit of the WNC is that it should reduce controversy in future base rate cases concerning the method and data chosen for weather normalization. The WNC will adjust achieved margin revenues toward the normalized level per account as used in the base rate case to forecast sales and revenues. St. No. 14, p. 23. NFG M.B., p. 42.

The OTS objected to NFGD's proposed WNC. Initially, the OTS notes that the Commission rejected the WNC when the Company first proposed it in its base rate case at Docket No. R-911912. The OTS further notes that NFGD proposed the WNC again in its base rate case at Docket No. R-00932548, but withdrew the proposal as part of a stipulation. OTS M.B., p. 111. The OTS is now opposed to NFGD's third attempt to establish a WNC for a variety of reasons.

First, the OTS contends that the WNC is designed to effect a reconciliation of margin revenues, which is contrary to Pennsylvania ratemaking practice. The OTS argues that reconciliations are only allowable in Section 1307(f) and 1307(a) filings. Id., pp. 114-115. Citing the Commission's Final Statement of Policy Regarding Recovery of Take-or-Pay Expenses set forth at Docket No. L-880043, the OTS asserts that approval of the WNC would violate the "standard ratemaking principle that all costs allowed in base rate proceedings be recovered on the basis of the utility's ability to project, not sufficiently guarantee, its sales and throughput." Id., p. 115. Moreover, the OTS argues that the proposed WNC seeks to guarantee a certain level of revenue and therefore profit, thus violating the traditional regulatory principle that a utility be allowed an opportunity, not a guarantee, to earn a fair rate of return. Id., pp. 115-117.

The OTS also contends that the WNC would reduce NFG's incentive to control costs. The OTS asserts that the recovery of a substantial portion of NFGD's total costs relating to the residential and commercial/public authority classes is already largely guaranteed through the 1307(f) reconciliation of gas costs and through customer charges. The OTS argues that the WNC would largely guarantee the recovery of the remaining margin revenue for these respective classes, thus eliminating any incentive for the Company to control margin costs. The OTS asserts that this is contrary to the public interest.

Id., pp. 117-118.

Another reason for the OTS' opposition to the WNC is its contention that it will not allow customers to realize the gas bill savings they would otherwise experience through conservation measures in a colder than normal winter. The OTS asserts that this would penalize conservation efforts, in contravention of statutory and Commission intent to encourage such efforts. Id., pp. 118-119.

Finally, the OTS contends that the WNC would complicate billing, and is not acceptable to NFGD's customers. In this regard the OTS notes that each of the seven customers who testified at the public input hearing were opposed to the WNC. Id., pp. 119-120. The OTS argues that under the WNC, customer bills would send inappropriate and confusing messages since bills will be higher than expected when the weather is warmer, and lower than expected when the weather is colder. OTS R.B., p. 47.

Should the WNC be approved in this proceeding, the OTS submits that NFGD's rate of return on common equity should be reduced to recognize the lower risk the Company would face with regard to the volatility of its earnings as a result of the WNC. Specifically, the OTS recommends a reduction of 25 basis points, which, the OTS contends, is identical to the 25 basis points downward adjustment to the cost of equity proposed by NFG's New York Division when it first proposed a WNC in New York. OTS M.B., pp. 120-121.

The OCA also objects to NFGD's proposed WNC for reasons similar to those of the OTS. Like the OTS, the OCA notes that the Commission rejected the WNC in NFG's 1991 rate case. OCA M.B., pp. 218-219. The OCA argues that the WNC is inconsistent with sound principles of utility ratemaking because it protects the Company from the risk of weather variations, and removes the incentive for the Company to manage its operations as efficiently as possible. Id., pp. 220-221. The OCA also provides arguments similar to those of the OTS with regard to customer confusion, the hindering of conservation efforts, and the violation of the regulatory principle that utilities be allowed an opportunity, not a guarantee, to recover a certain level of revenue and profit. Id., pp. 222-226. In addition, the OCA makes the following argument concerning the proposed WNC: [W]ith annual changes to the clause outside of the context of a base rate proceeding, there would necessarily be changes to the utility's rates without consideration of the level of utility earnings. Thus, NFGD would be permitted to recover a certain fixed level of margin revenues without having to prove before this Commission that it is unable to earn a fair return at the time the weather is other than normal - even if its cost of capital may have decreased, its operating expenses may have decreased, or its operating revenues may have exceeded its own projections. Indeed, it is for this reason that a **Weather Normalization Clause** is wholly unlike a purchased gas cost mechanism or other sliding scale of rates designed to recover a particular expense, since in those instances the utility is required to show in a later proceeding that the costs it seeks to recover are actual, prudently incurred and subject to reconciliation.

Id., p. 223, citations omitted.

In response to the positions of the OTS and the OCA with regard to conservation incentives, the Company contends that there is no merit to these arguments. NFGD argues as follows: The operation of the WNC is indisputable. Customers who undertake conservation efforts would achieve the same level of savings with a WNC that they would have achieved under normal weather conditions without a WNC. That it, margin revenues savings would not be affected by weather conditions. The portion of the bill that is for recovery of purchased gas costs is not adjusted by the WNC, and therefore, with regard to revenues of recovery of purchased gas costs, the customer who conserves would save exactly the same amount regardless of the WNC. NFG M.B., p. 39.

With regard to the charge that the WNC would reduce NFG's incentive to control costs, the Company contends that such incentives would exist regardless of whether or not the WNC is approved. NFG argues that this is so because a utility is allowed to retain savings from any efficiencies achieved in its operations. Id., p. 40. Moreover, NFGD contends that without a WNC, abnormal weather can mask quality of management. In this regard, NFGD makes the following argument: For example, during periods of colder-than-normal temperatures, an inefficient utility can achieve its allowed rate of return. Similarly, during periods of warmer-than-normal weather, even an extremely efficient utility will not be able to achieve its allowed rate of return. With a WNC, however, where the effects of abnormal temperatures are removed, an efficient utility may have an opportunity to achieve consistently its allowed rate of return despite abnormal weather conditions, and an inefficient utility will have virtually no possibility of achieving its allowed rate of return. The WNC, by removing the effects of abnormal weather, allows quality of management to show. Results of operations will be based upon performance - not uncontrollable temperature variation. A WNC will increase management accountability. NFG R.B., p. 32.

Finally, NFGD contends that there is no merit to the argument that the WNC has or will, result in significant customer opposition. NFGD asserts that only a small percentage of the customers at the public input hearing spoke against the WNC. NFG M.B., p. 40. NFGD further argues that WNCs have been approved in 15 other states, and that there was no evidence provided in this case of customer opposition or commission withdrawal of the WNC in any of these states. Id., p. 41. NFGD asserts that it will provide a pamphlet to its customers to explain the WNC. Id., pp. 41-42.

The ALJ made the following disposition of this issue:

The WNC, despite the objections, has a certain appeal to it. In making the company less risky the equity return could be adjusted downward which could be beneficial to ratepayers. However, in following Commission precedent we feel compelled to reject the WNC as did the Commission when the company first proposed it in its rate case at Docket No. R-911912. (R.D. at 56-57).

In its Exceptions, NFGD notes that for the second time, an ALJ has ruled on its proposed WNC. And for the second time, notes the Company, the presiding ALJ spoke favorably of the WNC, but recommended its rejection for other reasons. The Company points out that in a previous rate proceeding involving NFGD, Docket No. R-911912, another ALJ found that the WNC had conceptual merit but recommended rejection due to anticipated customer reaction. NFGD continues that in the instant matter, ALJ Kashi recommended its rejection based upon the Commission's prior decision.

It is also argued that customer reaction provides no basis for rejecting the WNC at this time. According to NFGD, WNC's are becoming increasingly common. NFGD continues that there has been no movement to repeal any of the numerous WNCs nor has any party produced any Commission order or literature from any other jurisdiction indicating any material adverse reaction by customers to a WNC. NFGD adds that a WNC has been effective in its New York division since November, 1988. The Company points out that during the severe 1993-94 winter, its New York customers received substantial savings in the non-gas cost portion of bills. NFGD adds that during the past winter of 1993-94, its New York customers filed no complaints and made no inquiries concerning the WNC and the Company received inquiries concerning only seven of the approximately 4.1 million bills rendered over the previous winter. (NFGD Exceptions at 12).

The Company submits that the WNC has several substantial benefits. The Company contends that under the present system, during colder-than-normal temperatures, an inefficient management can achieve its allowed rate of return despite its inefficiencies. Conversely says NFGD, during warmer-than-normal temperatures, even an efficient utility cannot achieve its allowed rate of return while maintaining service. The WNC, asserts the Company, removes the effect of abnormal temperatures. The Company continues that an efficient utility with a WNC has a reasonable opportunity to achieve its allowed rate of return even in warm weather because it is not penalized for factors outside its control. However, conversely, an inefficient utility will not achieve its allowed rate of return in unusually warm weather even with a WNC. Thus, concludes NFGD, the quality of management can show by removing the effects of abnormal weather. (NFGD Exceptions at 12-13).

The Company submits that another advantage of the WNC is that it will make rates more affordable during cold periods. NFGD continues that some of the discontent at the public input hearings was due to high bills caused by the unusually severe 1993-94 winter. NFGD claims that if the WNC had been in effect during the past severe winter, bills to customers would have been reduced by approximately $ 3,965,000. The Company continues that the WNC would reduce the non-gas portion of bills when bills are highest because of higher use, and would increase bills when they are lowest due to reduced use. This, opines NFGD, would be a good and equal bargain for ratepayers. (NFGD Exceptions at 13).

The Company continues that the ALJ correctly found that the other parties' criticisms of the WNC are baseless. NFGD asserts that the WNC does not provide for reconciliation, thus there is no adjustment for lost load, lost customers or increased expenses. Moreover, adds the Company, a WNC will not defeat incentives for management efficiency, since utilities are entitled to retain savings from increased efficiencies between rate cases with or without a WNC. Finally, NFGD adds that a WNC would not defeat incentives for customer conservation, since most of a heat-sensitive customer's bill is the cost of gas, which will remain unchanged by the WNC. (NFGD Exceptions at 13-14).

In its Exceptions, the OTS agrees with the ALJ's recommendation that the WNC be rejected, but excepts to the ALJ's recitation of only one reason why the WNC should be rejected. Specifically, the OTS states that the reason offered by the ALJ is that the Commission had previously rejected the WNC. The OTS expressed concern that the recommendation in the matter before us is unsupported by specific findings of fact about the WNC based upon the record in this proceeding. In the OTS' view, the lack of specific record here, would make the ALJ's recommendation insufficient to withstand appellate review. The OTS notes that NFGD appealed the previous rejection of the WNC to Commonwealth Court (OTS Exceptions at 4).

At a minimum, urges the OTS, findings of fact should have been made to show that the current WNC proposal is substantially similar, in effect, to the WNC proposal which was previously rejected by the Commission, and that the reasons for the prior Commission rejection are equally applicable to the instant proposal. (OTS Exceptions at 4-5).

The OTS continues that the ALJ's decision adequately summarizes the various positions of the parties concerning the WNC, but then fails to specifically resolve the conflicting evidence which was presented. The OTS cites W.J. Dillner Transfer Company v. U.S., 277 F. Supp. 420, 426 (1967), for the proposition that the appraisal of conflicting testimony or other evidence, judging the credibility of witnesses and the evidence adduced, and a determination of the weight of evidence, is the exclusive function of administrative agencies, not appellate courts. Similarly, the OTS contends, that the Pennsylvania Commonwealth Court has stated that it is the province of the fact-finder, rather than the Commonwealth Court, to judge the weight and credibility of evidence in administrative matters. See Feldbauer v. Commonwealth, Department of Public Welfare, 83 Pa. Commonwealth Court 379, 480 A.2d 1253 (1984). The OTS adds that Burlington Truck Lines, Inc. v. U.S., 371 U.S. 156, 168, 83 S. Ct. 239, 245-246, 9 L.Ed.2d 207 (1962), stands for the proposition that an agency must make findings that support its decision, and must articulate a satisfactory explanation for its actions, including a rational connection between the facts found and the choice that is made (OTS Exceptions at 5).

According to the OTS, the evidence overwhelmingly supports rejection of the WNC, for the same reasons that a similar WNC was rejected in 1991, and for additional reasons which the Commission did not appear to address in its prior rejection. The OTS urges the Commission to specifically make the following findings of fact and to conclude based upon the following findings, which the OTS adds parenthetically, are not inconsistent with its findings regarding NFGD's 1991 proposal, the WNC should be rejected with prejudice. (Emphasis supplied by OTS). (OTS Exceptions at 6).

The OTS proposed finding of fact No. 1 follows: 1. The WNC would, at a minimum, reconcile margin recovery to normal weather and seeks to guarantee a certain level of return, which is contra to

Pennsylvania ratemaking practice. (Emphasis in Original).

The OTS submits that NFGD's proposed WNC, similar to that proposed in 1991, is designed to stabilize recovery of non-gas costs of service or margin to the extent that such revenues fluctuate due to variations between "normal" and "actual" temperatures. It is the view of the OTS that the removal of this risk of recovery due to weather unpredictability seeks to guarantee a certain level of revenue, rather than to allow the utility the opportunity to earn its authorized rate of return. The OTS states that this is because weather unpredictability is a substantial element in the variability of NFGD's margin revenues, and rate of return dollars are recovered in those revenues. The OTS continued that the Commission previously rejected the WNC in 1991 due in part to its impermissible guarantee of a level of return. The OTS urges the Commission to reject the WNC request, here, for the same reason. (OTS Exceptions at 6-7).

The OTS continues that due to WNC adjustments for recovery of non-gas costs of service, there is essentially a reconciliation of these margin revenues to the level allowed by the Commission in the Company's most recent base rate proceeding. At a minimum, says OTS, there is a reconciliation of the margin revenues associated with the differential between and actual and normal weather. The OTS submits that this reconciliation of base rate expenses is inconsistent with Pennsylvania ratemaking practice, and should be rejected. Thus, the OTS argues that a WNC should be rejected because, inter alia, it would impermissibly reconcile rate base expenses and guarantee a certain level of return which is contra to Pennsylvania ratemaking practice.

Proposed Finding of Fact No. 2 follows: The WNC will reduce efficiency incentives.

The OTS notes that at pages 52-53 of the R.D., ALJ Kashi has summarized the reasons why NFGD's proposed WNC would clearly reduce incentive to control non-gas costs through efficiency. The OTS adds parenthetically that the ALJ did not make a specific finding to that effect. The OTS indicates that about 78% of the total revenues for the residential class and 77% of the total revenues for the small commercial/public authority ("C/PA") are largely guaranteed to be recovered by NFGD through the purchased gas cost reconciliation and customer charges. The OTS continues that another 1.0% and .9% of total revenues for the residential and CP/A classes respectively is related to take-or-pay recovery. The balance of the revenues, which is about 21% and 22.1% for the residential and C/PA classes respectively, is sought by NFGD to be adjusted for weather variability by the WNC. (OTS Exceptions at 8).

The OTS continues that while the company has the ability to control costs that are recovered through margin revenue, there is simply no incentive to control those costs with a WNC in effect. The OTS concludes that there is no incentive because the WNC would largely guarantee recovery of margin revenue. The OTS asserts that it is not in the public interest to discourage utility cost control and for this additional reason OTS urges denial of the proposed WNC. (Id.).

Proposed Finding of Fact No. 3: Energy conservation may be compromised

The OTS notes that every witness in this proceeding, including NFGD witness, Mr. Pijacki, agreed that NFGD customers who weatherized their homes and/or purchased energy efficient appliances after last winter's cold weather will not realize the gas bill savings' that they would have otherwise have realized, in a colder than normal winter, if a WNC is approved in this case. This according to the OTS, would penalize conservation efforts in contravention of statutory and Commission intent to encourage conservation efforts. (OTS Exceptions at 9).

Proposed Finding of Fact No. 4 follows: The WNC complicates billing and is not acceptable to NFGD's customers as indicated by the public input testimony.

The OTS argues that the public input testimony of record indicates that the WNC is not acceptable to NFGD's customers as indicated in the record of public input sessions in Sharon and Erie. (OTS Exceptions at 9-10).

The Company responds to the OTS Exceptions by stating that contentions that the WNC would guarantee a certain level of return and reconcile base-rate expenses are erroneous. NFGD continues that the OTS witness agreed that there is no adjustment for lost customers; and there is no adjustment for changes in expense. Also, NFGD points out that there is no "E" factor reconciliation. (NFG Reply Exceptions at 5).

The Company disputes the OTS argument that the WNC would reduce incentives for efficiency. NFGD argues that the Company is at risk to control expenses between rate cases, and that the WNC does not change that. It is the view of NFGD that such risk gives the Company an incentive to control expenses for its own benefit between rate cases, and for customers benefit after rate cases. (Id.)

The Company addresses the OTS contention that customers will not realize the gas bill savings they otherwise would have realized in a colder-than-normal winter if a WNC is approved. NFGD counters that the WNC adjusts only the margin portion of the bill to a customer toward the level that would have been billed under "normal" temperatures. NFGD continues that during colder-than-normal periods, a WNC will produce savings that are greater than they would have been without a WNC. NFGD submits that a customer will pay reduced gas costs because of conservation and, because of the WNC, reduced margin. Conversely, during warmer-than-normal periods, the margin portion of the bill to a customer is increased slightly to the level that would be billed if temperatures were normal. Also, NFGD insists that customers will still receive gas cost savings from conservation. (NFG Reply Exceptions at 5-6).

Finally, the Company addresses the OTS contention that customer dissatisfaction is a reason to disallow the WNC. According to the Company, the OTS ignores the favorable experiences of many gas companies in many jurisdictions. (NFGD Reply Exceptions at 6)

In its Reply Exceptions, the OCA submits that the Company's position in support of the WNC is without merit. Specifically, the OCA does not disagree that customer bills would be more affordable with a WNC during colder-than-normal temperatures. However, the OCA notes that the same bills are less affordable during warmer-than-normal periods. Thus, the OCA concludes that the claimed benefit is not without a cost. (OCA Reply Exceptions at 7).

The OCA continues that the Company's witness admitted that a WNC rewards every utility regardless of the efficiency of their operations. Moreover, the OCA repeats that, contrary to the company's position, by reducing the risk of a non-recovery of a portion of the Company's non-gas cost margin, the WNC would reduce the incentive to control expenses and keep rates as low as possible. Additionally says the OCA, through the reconciliation mechanism for purchased gas costs and the Customer charge, the Company is already able to collect a very large portion of its costs through fixed charges. The OCA states that a WNC would remove a significant amount of the weather-related risk. (OCA Reply Exceptions at 7-8).

In its Reply Exceptions, the OTS attacks the Company's assertion that the WNC is a "good and equal bargain for ratepayers." The OTS objects to the supporting reasoning advanced by NFGD that the bargain results from the reduction of the non-gas portion of the bills when they are highest due to high consumption and lowest due to low consumption. It is the position of the OTS that this reasoning sends absolutely the wrong conservation signals to ratepayers, in contravention of statutory and Commission intent to encourage conservation efforts. The OTS repeats the argument made in its Exceptions that a WNC would penalize customers who made conservation investments after last winter's severe weather because those customers will not realize the gas bill savings that they would have otherwise realized if the winter of 1994-95 is colder-than-normal. The OTS concludes that inverted conservation messages and conservation penalties are not a "good deal" for ratepayers. Thus, the OTS urges that the Commission reject the WNC with prejudice.

[9] Upon our careful consideration of the positions advanced by the parties herein, we will adopt the position advanced by the OTS in its Reply Exceptions. We agree with the OTS that approval of the WNC would send the wrong message to ratepayers regarding conservation, and would ultimately discourage customer conservation. Based upon the foregoing discussion we reject, with prejudice, NFGD's proposal to establish a WNC.

Accordingly, we will adopt the recommendation of the ALJ to reject the WNC, but not his supporting reasoning. The Exceptions of the OTS, to the extent consistent with the preceding discussion, and denied in all other respects. The Exceptions of NFGD are denied in their entirety.

LIRA REVENUES

The OTS, through its witness Thomas Maher, argues that NFGD has understated present residential rate revenue because the Company's calculations were based upon 1,000 LIRA customers instead of the actual number of customers currently served under that tariff. See, NFGD Ex. 103-A-1, p. 1; OTS Stmt. No. 2, pp. 42-43. NFGD witness Ring stated that as of June 15, 1994, there were only 771 customers being served under the LIRA rate. N.T. 457. NFGD provided no further updates to the number of LIRA customers subsequent to June 15, 1994.

Under the LIRA rate, customers pay a reduced residential customer charge of $ 5.21/month rather than the $ 11.68/month customer charge currently paid by other residential customers. In addition, LIRA customers pay only the 1307(f) rate for all gas sales (i.e. $ 4.2769/Mcf rather than the $ 5.9575/Mcf rate for the first block and the $ 5.6417/Mcf rate for the tailblock paid by other residential customers). N.T. 770. This produces a billing deficiency, on an annual basis, of $ 440 per LIRA customer. The calculation is shown on OTS Exhibit 2A, Schedule 6.

According to the OTS, since only 771 customers rather than 1,000 are on the LIRA rate, an additional 229 customers, over and above what NFGD has reflected in this case, are non-LIRA residential customers and will pay $ 440 more per year in their rates. This, asserts the OTS, results in additional residential revenue of $ 100,760 ($ 440 x 229 = $ 100,760).

The ALJ noted that at the time of preparation of Mr. Maher's testimony, the Company had a tariff provision (Supplement No. 39, page no. 31A, twelfth revised) which prohibited the addition of customers into the LIRA pilot program after the initial selection of 1,000 LIRA participants. OTS Stmt. No. 2, p. 43. The ALJ continued that while NFGD indicated during the hearings that it had filed a tariff supplement to delete this provision from its tariff, Mr. Maher testified that his LIRA revenue adjustment remained valid because it is doubtful the Company could enroll an additional 229 customers before the end of the future test year. N.T. 760-61, 795. (R.D. at 58).

The ALJ reached the following conclusion regarding this issue:

NFGD presented no rebuttal to this adjustment. The adjustment is reasonable as it properly reflects residential revenue at the appropriate tariff rate. Accordingly, it should be adopted. OTS has reflected this revenue adjustment of $ 101,000 in its Appendix, Table II, p.1. (Id.)

In its Exceptions, the Company repeats that the OTS adjustment, which was adopted by the ALJ, was based upon the actual LIRA customers as of June 15, 1994. NFGD points out that it has amended its tariff to permit additional enrollment of additional customers into the LIRA program. The Company opines that the Commission should courage it to enroll additional customers into the LIRA program, and reflect 1,000 LIRA customers in rates. (NFGD Exceptions at 14).

In its Reply Exceptions, the OTS characterizes the NFGD Exception as being without merit and urges its rejection.

[10, 11] Upon review of the issue, we found persuasive the position of NFGD that the Commission should encourage the Company to enroll additional customers in the LIRA program. We note further that we have encouraged, through our Policy Statement at 52 Pennsylvania Code, Chapter 69, Section 261, 52 Pa. Code, § 69.261, CAP programs such as NFG's LIRA program. Accordingly, we will grant the Company's Exception and not adopt the recommendation of the ALJ on this issue.

Industrial Revenues

The ALJ made the following Comments regarding this issue:

NFGD has removed or reduced volumes and associated revenue from the test year level for three LIS customers. OTS Stmt. No. 206, pp. 3-5. These customers are Franklin Steel (now projected to consume 0 Mcf due to business closure), Cytemp Specialty Steel (now projected to consume only 30,000 Mcf/year for plant protection) and PPG Industries (now projected to consume 0 Mcf due to bypass). Id. at pp. 3-5; NFGD Stmt. No. 12, p. 7.

While OTS witness Maher had originally disputed the certainty of these revenue losses, Mr. Maher accepted these adjustments in his surrebuttal testimony. N.T. 1256-57. As indicated in the summary schedules circulated by NFGD on August 8, 1994, and as included in the OTS Petition to Reopen, the net revenue effect of these lost volumes is $ 379,805 at present rates ($ 411,000 at tariffed rates minus $ 31,000 in purchased gas cost savings). The $ 379,805 revenue reduction amount has been reflected in the OTS Appendix tables. (R.D. at 58-59).

Since no party opposes the ALJ's treatment of this issue, we will adopt his action, as our own.

EXPENSES

1. Payroll

The ALJ introduces the discussion on payroll adjustments as follows:

Both OTS and OCA have proposed substantial adjustments to Distribution's payroll for the future test year ending November 30, 1994. Both OTS and OCA make adjustments using a lower number of employees than Distribution and both OTS and OCA would eliminate all post future test year wage and salary increases (See OTS St. No. 2, pp. 27-39 and OCA St. No. 3, pp. 39-45). OTS M.B. at pp. 71 - 83, OCA M.B. at pp. 55 - 76. In addition, OTS has proposed adjustments to expense levels for summer, part-time, temporary, other and overtime payroll. The Company, quite naturally, argues that all of these proposed adjustments are inappropriate, at least in substantial part, and should be rejected. NFGD M.B. pp.64 -76. (R.D. at 59).

1(a). Number of Employees; Employee Complement

NFGD originally filed its labor expense claim in this proceeding on the basis of a 520 employee complement. NFGD Stmt. No. 205, p. 10. This 520 level reflects the number of NFGD employees as of January 15, 1994. NFGD Stmt. No. 5, p. 5. However, by March 15, 1994, NFGD had 496 employees due to retirements. NFGD Stmt. No. 205, p. 10. While NFGD revised its originally projected employee complement down to 508 for the test year, the employee count remained at 496 as of the close of the record on July 28, 1994. NFGD Stmt. No. 205, p. 11; N.T. 1219. NFGD M. B. pp. 64 & 65.

Both OTS witness Maher and OCA witness Cotton recommended that a 496 employee complement level be used for determining labor and benefits expense. NFGD Stmt. No. 205, p. 10. This is the actual number of employees which existed at the close of the record, and therefore, argue both the OTS and the OCA, reflects the most recent level of employees which is known with certainty. OTS M.B. at 72, OCA M.B. at pp. 57-60.

According to the OTS, While NFGD witness Higley indicated that the Company intends to replace 12 of the retirees (for a total of 508), this expressed intent of the Company is pure speculation. NFGD Stmt. No. 205, pp. 10-11. OTS M.B. at 72. Additionally, argue the OTS and the OCA, while Mr. Higley implied that a 496 level may not be sufficient to maintain adequate service, NFGD's Assistant Treasurer Mr. Wright testified that NFGD's service had absolutely not been inadequate or marginal since the employee level dropped to 496. NFGD Stmt. No. 205, p. 12; N.T. 1044. Clearly, it is argued that the 496 level should be used for ratemaking purposes, rather than NFGD's speculative 508 employee complement level.

The OCA argued that as a result of the effects of the two special retirement programs, Distribution's employee complement dropped to 496. This employee complement is substantially lower than at any previous time in recent history. The average annual number of employees for 12-month periods ending November 30 is provided in summary form at page 11 of Statement No. 205 as follows:

** See Table in Original. **

Monthly details of the employee complement are provided in response to Interrogatory OCA-1-51 (OCA St. No. 3, Appendix A). (R.D. at 61).

The OTS and the OCA argue that their adjustments are based upon the most recent employee complement level available at the close of the evidentiary record, and although such statements are factually correct (N.T.219), such contentions, argue NFGD, would produce a result grossly unfair to the Company. NFGD argues that the 496 figure fails to take into consideration the "domino" effect or the "rebound" effect. NFGD M.B.at pp. 66-67.

Mr. Higley explained that there are legitimate reasons for utilizing a higher than actual number of employees in calculating the Company's future test year payroll expense. He first testified that the positions of the 12 normal retirees were included in his future test year payroll calculation because these retirements were more like early retirements than "normal trends." NFGD Stmt. 205 at 13. He explained that, of the 12 to be replaced, five are for Union Local 22 meter readers for which there are open requisitions that are outstanding and the other seven are for management replacements that are subject to the "domino" effect. Id. at 11. According to Mr. Higley, the "domino" effect occurs when there are promotions to both replace retirees' positions and to fill vacancies caused by the promotions to replace retirees' positions. See NFGD M.B. at 66. Hence, the Company's position is that the "domino" effect will, in part, cause the need for full replacement of the 12 normal retirees. For this reason, Mr. Higley anticipates a total level of 508 employees. NFGD St. 205 at 11.

Mr. Higley also described another phenomenon called the "rebound" effect which occurs when employee levels that have dropped suddenly as a result of early retirement increase to a new "stabilized" level. NFGD St. 205 at 12-13. For this reason, according to Mr. Higley, the Company could easily anticipate a level of 511 employees instead of the 508 level it intends to maintain.

Id.

The OCA and the OTS oppose both the initially proposed 520 and the revised 508 employee complements used to calculate the Company's payroll expense as unsubstantiated. First, the Company has not shown that a higher employee level than currently in place is needed to provide safe and adequate natural gas service. Secondly, the Company has not substantiated its claim that a "rebound" effect will occur in the future test year to boost current employee levels to the "anticipated" 511 or 508 employees. On the contrary, within the future test year, the Company has shown a significant decrease in employee levels from January, 1994 through July, 1994. Rather than evidencing a "rebound" effect, NFGD Exh. 205-B, Schedule 2 actually shows a steady overall decrease in employee levels from September, 1989 to March, 1994. Based on this historical trend, there is no evidence that the "rebound" effect would occur within the future test year. Additionally, the Company does not dispute that its permanent employee levels have been historically declining.

OCA witness Cotton identified two factors that demonstrate NFGD's declining permanent employee levels: (1) reductions in permanent staff coupled with increases in non-permanent sources of labor and (2) voluntary early retirement programs. OCA St. 3 at 39-40. As data provided by Company witness Higley reveals, the Company's permanent payroll has decreased over the most recent five years, from a high employee complement in 1990 of 538 to a low of 496 in 1994. NFGD St. 205 at 11. Simultaneously, the OCA submits that NFGD's claims for temporary part-time, summer and "other" payroll costs reflect substantial increases in each category over the past years. See OTS Cross Exam. Exh. 15. Similarly, the Company's history of overtime costs reveals a steady and substantial increase in overtime expense over the past five years. Id.

The ALJ proffered the following summary of these points including the most recent actual data on the permanent employee level and non-permanent labor expenses at page 64 of the R.D. as follows:

** See Table in Original. **

OTS Cross Exam. Exh. 15; NFGD St. 205 at 11, 15.

The ALJ found that the data in the above diagram demonstrates that a comparison of the most recent data provided by NFGD for years 1992 and 1993, reveals that part-time temporary employee costs have increased by 44%; summer employee costs by 24%; "other" employee costs by 81%; and overtime costs by 18%.

The ALJ continued that this data reveals that, while there has been a steady decrease in the level of permanent employees, NFGD has been increasing its non-permanent employee levels. The ALJ noted that NFGD witness Wright testified that the Company has been reducing its employee count in Pennsylvania since 1981 as a cost-cutting measure. NFGD St. 219 at 6. The ALJ noted further that Mr. Wright testified that at September 30, 1981, Distribution-Pennsylvania employed 604 employees as opposed to the currently revised 508 employees reflected for the period ending November 30, 1994.

Id. Moreover, that ALJ cited Mr. Wright's statements that, "While other Northeast utilities have been touting recently announced employee reduction plans, Distribution has been trimming its workforce for many years"; and that NFGD "has increased its use of part-time and contract labor to mitigate the requirement for full-time employees." R.D. at 65. The ALJ concluded that clearly, by admission, NFGD shows a history of reducing permanent staff levels. The ALJ adds that recent cost control measures have included increasing non-permanent labor to reduce the requirement for full-time employees. Moreover, the ALJ asserted that, "NFGD has not come forward with any compelling evidence that would justify the use of a higher than actual employee level for future test year payroll projections." (Id.)

The ALJ commented that, contrary to NFGD's assertions, the recommendation of OTS and OCA does not ignore historical experience. In fact, he continued that using an employee level of 496 is actually consistent with NFGD's history of decreasing employee levels. The ALJ cited the testimony of NFGD witness Wright, that the Company has been deliberately trimming its work force "for many years" in order to cut costs. In fact, continued the ALJ, Mr. Wright testified that in 1981, NFGD's employee level was at 604 and in 1990, the Company employed 538 people as compared to the current level of 496. At the same time, found the ALJ, NFGD has been drastically increasing its non-permanent employee levels over the past years and incorporates a further increase in non-permanent labor in this case. The ALJ opined that while it is true that NFGD has never operated at a level as low as 496 employees, actual historical data shows a consistent downward trend in permanent employee levels which, according to Mr. Wright, is a deliberate attempt on the part of Distribution to cut costs. Thus, concluded the ALJ, limiting the NFGD permanent workforce to a level of 496 employees would not be "grossly unfair" or "unreasonable." The ALJ also points out that Company witness Wright testified that NFGD has continued to provide safe and adequate service at an employee level of 496. (R.D. at 66).

ALJ Kashi continued that the recommended adjustment does not ignore the Company's history of early retirements and the "rebound" effect. The ALJ found that ultimate effects of early retirements and the "rebound" are subsumed in the 496 employee level. The ALJ further found that the Company has not shown that the "rebound" effect will occur in the future test year to boost current employee levels to the anticipated 508 or 520 levels. The ALJ said that there is no evidence that the "rebound" effect would not be offset by the trend of decreasing permanent employee levels and increasing non-permanent employee levels. Accordingly, the ALJ recommended the use of an employee complement of 496. (Id.)

The ALJ provided the following summary of the recommended adjustments to wages and related benefits:

** See Table in Original. **

(R.D. at 67).

We will discuss, in detail, the individual components of the employee complement reduction, as each relates to the ALJ's recommended reduction in the complement of employees from 508 to 496. We will defer discussion on the component of each adjustment which refers to post-test year pay increases until the section of our payroll discussion where the Company's specific claim is addressed.

1(b). Supervisory Payroll

OTS witness Maher developed his supervisory payroll adjustment using the March 1994 level of 102 instead of the Company's 109 employee level for this pay group (which accounts for 7 of the 24 employees who have retired since January). OTS Stmt. No. 2, pp. 32-33. The OTS has addressed why the post-retirement level of 496 employees should be

used for ratemaking purposes and this is consistent with the use of 102 employees for developing supervisory payroll.

Mr. Maher also recommended that the Company's projected 4.8% pay increase for this group, which is claimed to be effective 1-1-95, be denied for ratemaking purposes. See, NFGD Ex. 104-A-1, p. 2. The OTS contends that Company has included eleven months of this projected post-test year wage increase in its future test year claim, so that the 4.8% increase is reflected up to 11/30/95 (i.e. a full year beyond the end of the future test year). NFGD Stmt. No. 205, p. 19. The OTS contends that there was no similar inclusion, by the Company, of revenues projected to be received from ratepayers beyond the end of the future test year. N.T. 206. Thus according to the OTS, the matching principle, previously discussed, is being violated.

In addition, Mr. Maher testified that the 1/1/95 4.8% increase is a projected post-test year increase which is not subject to a contract. N.T. 335. The OTS maintains that this Commission has previously rejected post-test year wage adjustments, such as this adjustment, which are not supported by a contract.

See e.g., Pa. P.U.C. v. Columbia Gas of PA, supra (1984).

The ALJ made the following disposition of this issue: For all the above reasons, we recommend that Mr. Maher's supervisory payroll adjustment be adopted. Mr. Maher revised this adjustment during surrebuttal to reflect a 32.2% n12 benefits loading factor for the seven supervisory employees who retired, instead of the 49.3% factor previously used for the computation. This was done to recognize the 17.1% portion which relates to OPEBs expense, because this expense does not necessarily decline when an employee retires. NFGD Stmt. No. 205, p. 18; OTS Ex. No. 2A, Sched.

12, p. 6. Mr. Maher's revised supervisory payroll adjustment (O&M expense portion), as calculated on OTS Exhibit No. 2A, Schedule No. 12, p. 3 (revised) is $ 570,145. This reflects an expense allocation percentage of 72.08%, as shown on OTS Cross Examination Exhibit 16 for O&M expenses. (R.D. at 71).

1(c). Clerical Payroll

OTS witness Maher developed his clerical payroll adjustment using the March 1994 clerical employee number of 100, rather than the 105 level used by the Company to develop its claim. OTS Stmt. No. 2, pp. 34-35. This accounts for an additional five employees of the 24 which have retired since January, and is consistent with the use of a 496 employee complement level previously discussed.

Mr. Maher also recommended that the Company's projected 3.8% pay increase for this group, which is claimed to be effective 1-1-95, be denied for ratemaking purposes. See, NFGD Ex. 104-A-1, p. 2. The OTS repeated that the Company has again included eleven months of this projected post-test year increase in its future test year claim, so that the 3.8% increase is reflected up to 11/30/95 (a full year beyond the end of the future test year). NFGD Stmt. No. 205, p. 19. Again, the OTS asserts that there was no inclusion of revenues projected to be received beyond the end of the future test year, and therefore, the matching principle is again being violated. N.T. 206.

In addition, the OTS repeats that the 3.8% projected post-test year increase is not subject to a contract. N.T. 335-36. For the reasons previously stated, the OTS urges that this proposed increase should not be reflected in rates at this time.

Mr. Maher's revised clerical payroll adjustment (72.08% O&M portion), which reflects the 32.2% benefits loading factor previously discussed, is $ 246,229. The rate base portion (27.92%) is $ 95,376. The ALJ noted that the calculation which supports this adjustment was entered into evidence as OTS Exhibit No. 2A, Sched. No. 12, page 3 (revised). The ALJ recommended that the adjustment be adopted. (R.D. at 74).

1(d). Bargaining Group Payroll

(Local 2279 And Locals 22 and 23)

OTS witness Maher developed his bargaining group payroll adjustments using the March 1994 level of 158 for Local 2279, rather than the 164 used by the Company to develop its future test year claim. OTS Stmt. No. 2, pp. 36-37. Similarly, Mr. Maher used 136 employees in Locals 22 and 23, instead of the 142 level used by the Company. Id. at 37. This accounts for the remaining 12 employees who have retired since January, and is consistent with the use of a 496 employee complement (which was the employee level as of the close of this record).

Mr. Maher also recommended that the projected 2.69% (annualized percentage) increase ($ 170,348) to Local 2279, to be effective 4/13/95, be rejected for ratemaking purposes at this time because it goes far beyond the future test year (increased wages are reflected up to 11/30/95). Id. at 37; NFGD Stmt. No. 205, p. 19; NFGD Ex. 104-A-1, p. 2. Also, these projected expenses do not match the revenue projection time frame (projected revenues are cut off as of 11/30/94). OTS Stmt. No. 2, p. 36.

Similarly, Mr. Maher recommended that the projected 2.53% (annualized percentage) increase ($ 137,650) to Locals 22 and 23, to be effective 5/1/95, be rejected for ratemaking purposes at this time, for the same reasons the projected post-test year increase to Local 2279 should be rejected.

The ALJ found that Mr. Maher's bargaining unit adjustments are reasonable and properly reflect the matching of revenues and expenses, to the test year level. These adjustments, which have been revised in surrebuttal to reflect the 32.2% benefits loading factor previously discussed, are $ 383,089 (72.08% O&M expense portion) for Local 2279 and $ 350,228 (72.08% O&M portion) for

Locals 22 and 23. The ALJ noted that the calculation which supports these adjustments was entered into evidence as OTS Exhibit No. 2A, Schedule No. 12, page 4 (revised). Further, the ALJ noted that the OTS has reflected these adjustments in its Appendix tables.

In its Exceptions, NFGD notes that it has reduced its Pennsylvania complement to reduce costs. NFGD continues that as of September 30, 1981, it had 604 Pennsylvania employees. At December 31, 1992, the permanent employee complement in Pennsylvania had been reduced to 535, which the Company computes to be a reduction of 11% in approximately 11 years. During 1993, continues NFGD, there was a further reduction in its Pennsylvania employee complement to 520 employees, a one-year reduction of nearly 3%. The Company notes that the 520 employee complement level was contained in its initial filing. (NFGD Exceptions at 14).

NFGD continues that during early 1994, it implemented an early retirement program and a special "90-plus" retirement plan. As a result of these two programs, NFGD states that during the first half of 1994, the employee complement was reduced by 24 retirements, to the level of 496 employees. This, notes the Company, was the level considered representative by the ALJ, for the time that the rates made in this proceeding will be in effect. (NFGD Exceptions at 14-15).

NFGD contends that in reaching this conclusion, the ALJ ignored its evidence concerning a "rebound" effect. The Company continues that when an early retirement program is implemented, the number of employees who will use the program is unknown. According to NFGD, retirement programs will rarely produce the optimal employee complement. The Company continues that in earlier programs, there was a rebound effect because employee levels were reduced below optimal levels. On average, avers the Company, 54% of the employees that retired during programs in 1985 and 1987, were replaced following such programs. The Company explained that it expected that the same effect would occur with the 1994 program. NFGD concludes that based upon the prior experience, it expects 12 of the 24 retirees will be replaced to bring the complement back to 508. (NFGD Exceptions at 15).

NFGD continues that there is a second effect which must be considered with regard to retirement programs which the Company refers to as the domino effect. According to NFGD, when supervisory retirements occur, such positions are filled predominately from within the Company. Therefore, according to the Company there must be a further selection of an individual to replace the promoted employee and so on, until an entry level position becomes vacant. NFGD contends that the process is time consuming, and avers that the domino effect prevented the Company from hiring new employees to replace retiring supervisory employees prior to the close of the record. NFGD submits that there are seven such supervisory replacements in the process of undergoing the domino effect. The remaining five employees, according to NFGD, are for union meter readers, for which there were open employment requisitions at the end of the evidentiary record. (Id.)

The Company adds that in NFGD's 1988 rate case, the Commission recognized the domino and rebound effects related to early retirements and approved its projected complement under very similar circumstances. The Company concludes that it would be unreasonable to impute a precipitous drop in the employee complement from 535 as of January 1, 1993, to 496 in May 1994, a reduction of 7.39% in less than 18 months. (NFGD Exceptions at 16).

The OCA in its Reply Exceptions, counters the Company's argument that it has ignored the rebound and domino effects. The OCA notes that the ALJ at page 66 of the R.D. states that the OCA and OTS recommendations did not ignore the said effects, but that the Company failed to show that the rebound effect would occur in the future test year to the anticipated 508 or 520 employee level. The OCA also argued that in the Company's 1988 rate case, the Commission did not recognize the domino effect. (OCA Reply Exception at 10).

In its Reply Exceptions, the OTS asserts that the Company had not come forward with any compelling evidence that would justify the use of a higher than actual employee level for future test year projections. The OTS insists that the expressed intent of the Company to replace 12 of its retirees (for a total of 508) is speculative and without record support. (OTS Reply Exceptions at

9-10).

Like the OCA, the OTS disputes the Company's assertion that the Commission had considered the rebound and domino effects in NFGD's 1988 rate case. The OTS submits that the case before us, is distinguished from the prior cases in that the Company was much more active in recruiting and hiring replacements, and actually had replaced 20 of 30 retirees by the close of the record in that proceeding. Here, claims the OTS, not one replacement has been hired for the 24 total retirees in the seven-month span between the time that the retirements commenced, January 1, 1994, and the close of the record. (OTS Reply Exceptions at 10).

[12] Upon review of the issue, we find credible the Company's Testimony and Exception that it was actively seeking, and in fact, had requisitions in order to hire 5 employees in local 22 to replace those who had retired under the early retirement program. Therefore, we will allow a complement of 501 customers, as opposed to the 496 recommended by the ALJ.

The computation of the OTS's adjustment to eliminate 6 positions, with a total dollar value of $ 350,228, in bargaining unit 22 consisted of the elimination of the pay and benefits of the six positions ($ 212,578) and the elimination of a pay increase effective May 1, 1995 ($ 137,650). Since we will allow payroll expense for 5 of the six employee positions, the payroll and benefit adjustment is reduced to $ 26,016. In the next section of this Opinion and Order will address the issue of post-test year pay increases.

2. Post Test Year Payroll Increase

As discussed previously in our disposition of the employee Complement issue, NFGD proposed to include in pro forma payroll expense a 3.8% payroll increase to become effective January 1, 1995, and another pay increase for Locals 22 and 23 to become effective May 1, 1995. The OTS opposed inclusion of this claim in expenses for the following reasons discussed previously herein: 1) the increase is not supported by a union contract; 2) the Commission has previously rejected similar claimed increases not supported by the contract; and 3) the increase was projected for eleven months beyond the end of the future test year, with no similar reflection of revenues, thus violating the matching principle. As discussed previously, the ALJ adopted the OTS's proposed adjustment on this issue.

In its Exceptions, NFGD argues that the ALJ recommended reversal of an uninterrupted decade of Commission policy with regard to post future test year wage and salary increases but rejecting all such increases proposed in this proceeding. NFGD cites its 1990 rate case, Pa. P.U.C. v. Pennsylvania-American Water Company, docketed at No. R-932670 (Order entered July 26, 1994), and Pa. P.U.C. v. UGI, docketed at No. R-932862 (Order entered July 27, 1994), for the proposition that the Commission has been willing to reach out somewhat beyond a future test year for reasonably known and certain salary increases that will become effective shortly after new rates become effective. (NFGD Exceptions at 17-18).

The Company continues that the ALJ's statement that the wage increase will become effective a full year beyond the end of the test year is erroneous. NFGD maintains that the pay increase in question will become effective January 1, 1995, not November 30, 1995. (NFGD Exceptions at 18).

The Company concludes that a utility will have no reasonable opportunity to earn a fair return if wage and salary increases in the year following the rate increases are not reflected in the rate allowance. The Company urges the Commission not to reverse what NFGD considers to be past precedents on this issue. (NFGD Exceptions at 19).

In its Reply Exceptions, the OTS counters that it has previously distinguished the Pennsylvania-American, and UGI decisions in its Reply Brief. The OTS continues that while the Commission has allowed post-test year contractual increases, NFGD in this case, has included the dollar effect of all increases, contractual and non-contractual, up through November 30, 1995.

Additionally, the OTS notes that NFGD has projected that it will file another base rate increase in early 1995. The OTS anticipates that the test year in that case will likely be from December 1, 1994, through November 30, 1995. Therefore, asserts the OTS, there is no reason why the Company cannot wait until that time to file its 1995 base rate claims for labor expense, and thereby comply with the matching principle. (OTS Reply Exceptions at 12).

In its Reply Exceptions the OCA argues that most of the wage increases claimed by the company are non-contractual and speculative estimates of wage increases. The OCA maintains that the Company has not provided the type of proof required by the Commission to support its proposal for supervisory salary increases. (OCA Reply Exceptions at 10-11).

The OCA notes that in NFGD's 1990 rate increase and in UGI, the Commission emphasized the Company's commitment to the increases based upon communication to the affected employees. Here, the OCA submits that in the absence of such a commitment the Company's claim should be disallowed. (OCA Reply Exceptions at 11-12).

[13] Upon consideration of the position of the parties, we agree with the ALJ's recommendation that the claimed post-test year payroll increases be denied. First, we agree with the OTS and the OCA that the increases are speculative and not supported by contract. Moreover, we adopt the OTS argument that since NFGD projects the filing of a rate case in early 1995, and such a projection is consistent with the Company's recent filing history, it will have the opportunity to reflect in rates the full impact of any 1995 wage increase which will have an effect upon the profitability of the utility. Accordingly, we will adopt the reasoning and recommendation of the ALJ on this issue. We will deny the Company's Exception.

3. Temporary, Part-Time; Summer; Other And Overtime Payroll.

NFGD based its temporary, part-time; summer; other; and overtime labor claim on the actual levels for the historic test year ended November 30, 1993. OTS Stmt. No. 2, p. 28. However, as indicated in OTS Cross Examination Exhibit No. 15, the historic test year amount for each of these four pay groups is the highest of each of the past three years. In fact, the historic test year level is the highest for all pay groups, with the exception of the summer pay group, since 1989. Id. at 28.

Accordingly, OTS witness Maher proposed adjustments to the projected labor claim for these four pay groups (also referred to as Miscellaneous pay groups), based on a three year average of actual labor expenses for the twelve months ended November 1991, 1992 and 1993. Id. at 29. Mr. Maher's original adjustments, based on the three year average, are shown on page 29 of OTS Statement No. 2. However, during rebuttal, NFGD witness Higley contended that Mr. Maher should have computed his average based on the payroll level at January 1, 1994. Mr. Higley prepared a schedule (NFGD Ex. No. 205-B, revised 7/25/94) to show this revised calculation. Mr. Maher accepted this adjustment to his computation, and has recomputed his adjustment, using the revised averages from Mr. Higley's exhibits.

The ALJ proffered the following schedule which shows the computation of the OTS adjustment (before O&M allocation), using the averages from revised NFGD Exhibit No. 205-B:

** See Table in Original. **

(R.D. at 69).

Also the ALJ pointed out that, with the exception of the "other" pay group, NFGD has increased the historic test year actual expense by 4.10% and 3.8% to reflect wage increases effective 1-1-94 and proposed to be effective 1-1-95, respectively. NFGD Ex. No. 104-A-1, p. 2. Mr. Maher opposed recognition of the proposed 3.8% increase at this time for ratemaking purposes.

Mr. Maher, argued that the 3.8% increase is not supported by a union contract (N.T. 335-36) and absent a contract, NFGD has no legal obligation to increase the salary level to these wage groups.

OTS Stmt. No. 2, p. 29. The OTS argues that the Commission has previously rejected projected post-test year wage increases, such as these, which are not required by contract. See,

Pa. P.U.C. v. Columbia Gas of PA, 58 Pa. P.U.C. 555, 583, 62 PUR 4th 1755 (1984); Pa. P.U.C. v. Duquesne Light Co., 54 Pa. P.U.C. 695, 43 PUR 4th 27 (1981). It is the position of OTS these expenses lack the degree of certainty necessary for proper ratemaking.

The OTS continued that NFGD has reflected eleven months of this increase in its filing, i.e., from January 1, 1995 to November 30, 1995. This, the OTS asserts, is a full year beyond the future test year. The OTS asserts further that revenues have not similarly been reflected (N.T. 206) and therefore, the matching principle is violated. OTS Stmt. No. 2, pp. 29-30.

The denial of the 3.8% post-test year increase results in a downward adjustment to NFGD's labor claim of $ 39,907, as computed on OTS Exhibit No. 2A, Schedule 7. In addition, the recommended reduction of $ 132,487 to the historic test year salary levels reduces the 4.1% increase, effective 1-1-94, by $ 5,432 ($ 132,487 x .041 = $ 5,432). (R.D. at 70).

To be consistent with the use of a three year average of historical payroll expense for the four pay groups, Mr. Maher used a three year average of the expensed percentage of labor for these same years. The data to compute this average was admitted into the record as OTS Cross Examination Exhibit No. 16. Mr. Maher's average expense percentage, as calculated in OTS Statement No. 2, p. 31, is 70.93%. This percentage was used in the OTS Appendix tables to allocate these miscellaneous pay group adjustments between expense and capital, and results in a $ 126,132 expense disallowance for these payroll groups, computed as follows: $ 132,487 + $ 5,432 + $ 39,907 = $ 177,826 $ 177,826 x .7093 = $ 126,132

In addition, there is an associated payroll tax disallowance of $ 14,937, of which $ 10,595 is the expense portion ($ 14,937 x .7093). The $ 14,937 payroll tax disallowance is computed using the 8.4% payroll tax factor supplied by the Company. See, OTS Ex. No. 2A, Sched. 12, p. 6 ($ 177,826 x .084 = $ 14,937).

The ALJ noted that Mr. Maher did not propose a benefits adjustment for these four pay groups because benefits are generally not applicable to these categories of pay. OTS Stmt. No. 2, p. 31. The ALJ found the adjustments proposed by the OTS reasonable, consistent with proper ratemaking and recommended their adoption. The ALJ noted further that the OTS has reflected these adjustments in its Appendix tables. (R.D. at 71).

In its Exceptions, the Company argued that the ALJ erred in adopting the OTS adjustment because in the Company's view it is improper to use a three-year average level of temporary payroll when the permanent employee count has declined and temporary payroll has increased. NFGD continues that the three-year average used by the OTS extends back to 1991 when the Company's permanent employee count was 537. NFGD also discussed the declining number of employees during the said three-year period. NFGD adds, by way of a footnote, that if the recommended complement level of 496 were adopted, consistency would require a temporary payroll expense $ 100,000 in excess of the amount that the Company claimed in its filing. Also, the Company claims to have demonstrated that its actual expenses for temporary labor exceeded its claim by $ 100,000. The Company, however, submits that it did not update its claim, because it proposed an employee complement higher than 496 employees. (NFGD Exceptions at 16-17).

In its Reply Exceptions, the OTS contends that the Company's argument that the temporary payroll be increased by $ 100,000 if the complement level is set at 496 employees should be disregarded. The OTS asserts that it is too late in the procedure for a party to be filing "rebuttal" expense claims. (OTS Reply Exceptions at 11).

[14] We agree with a portion of the ALJ's recommended resolution of the temporary employee issue. First, the component of the claim which results from the projection of post-test year expense claim of $ 39,907 shall be disallowed consistent with our previous detailed discussion of this issue.

Further, we agree with the OTS that the Company's claim for an additional $ 100,000 in expense for temporary employees is inappropriate at this point in the proceeding. Moreover, our decision to allow a payroll complement of 501 employees renders the argument moot. However, we find the Company's argument that since the complement of permanent employees has decreased dramatically in recent years, we shall grant the Company's Exceptions and allow the adjustment with the exception of the post-test year pay increase.

4. Wages from NFG Supply and NFGD (NY Division).

The Company is including within its labor expense claim, the labor expense charged to NFGD from NFG Supply (an affiliate) from the New York Division of NFGD. See, NFGD Ex. 104-A-1, pp. 3-4. This labor expense claim includes the annualized effect of a projected 3.8% wage increase, claimed to be effective in February 1995, for the NY Division employees, in the amount of $ 90,812. Also included is the annualized effect of a projected 3.8% increase, claimed to be effective April 1995, for the NFG Supply employees, in the amount of $ 28,604. NFGD Ex. 104-A-1, pp. 3, 4, column 9.

Mr. Maher has proposed that both of these projected post-test year increases be rejected. The proposed increase to the NY Division employees is not supported by a contract and the effect of both increases is reflected in this proceeding from the proposed effective date of the wage increase, until 11/30/95 (a full year beyond the end of the future test year). This, according to the OTS, creates a mismatch of revenue and expenses and should be disallowed. Mr. Maher's adjustment, which is $ 163,480 (labor expense plus benefits), is calculated on page 39 of OTS Statement No. 2. The ALJ recommended that the adjustment be adopted. (R.D. at 76). Based upon our previous discussion, we will adopt the reasoning and recommendation of the ALJ.

5. Capitalized Labor

OTS witness Maher proposed rate base adjustments to remove the capitalized labor portion of the labor and benefits adjustments previously discussed. The capitalized portion of the temporary, part time; summer; other; and overtime pay group is 29.07% (100% - 70.93% three year average expense allocation = 29.07%), while the capitalized portion of the remaining NFGD - PA pay groups is 27.92% (100% - 72.08% O&M expense allocation = 27.92%). OTS Stmt. No. 2, pp. 47-48. This adjustment, according to the OTS, is necessary to fully remove the rate effect of NFGD's inclusion of 24 employees which do not exist.

NFGD has objected to the adjustment, contending that this adjustment would somehow adversely affect its construction program. NFGD Stmt. No. 205, p. 25. The ALJ opined that this argument makes no sense. The ALJ noted that NFGD witness Higley, acknowledged that the reason for Mr. Maher's rate base adjustment is to remove labor which NFGD has capitalized, for employees which, in OTS' view, the Company no longer has. N.T. 1233-34. The ALJ found previously that NFGD has apparently functioned well since March 1994 with 496 employees, and he found no evidence that customer service has been compromised. N.T. 1044. The ALJ concluded that NFGD's objections should be disregarded and OTS' rate base adjustments should be adopted. (R.D. at 77).

The ALJ points out that rate base adjustment for salaries totals $ 656,305, as calculated using the salary adjustments in OTS Exhibit No. 2A, Sched. No. 12. The associated depreciation expense adjustment, at 3.1% of $ 656,305, is $ 20,345, and the corresponding accrued depreciation adjustment is 1/2 of the depreciation expense adjustment, or $ 10,173 (Id.).

In its Exceptions, NFGD characterizes the adjustment as a "follow-up" to the employee complement levels adjustment. However, the Company proffers another reason for reversing the ALJ's decision to adopt the adjustment.

The Company argued that the ALJ erred in his determination that the payroll adjustment would affect NFGD's construction program. The Company argued that its construction program is not driven by the number of employees, but is driven by the need to undertake construction to maintain safe and adequate facilities. Therefore, concludes the Company, if the employee complement is reduced to the point that it would affect the construction program, outside contractors would be substituted for employees to ascertain that the construction work is done in a timely manner consistent with engineering principles and standards. Thus, the Company states that the level of construction activity is unrelated to the level of employee complement. (NFGD Exceptions at 19-20).

In its Reply Exceptions, the OTS responds to the Company's argument regarding the use of outside contractors by stating that NFGD did not present proof of any outside expenditure. (OTS Reply Exceptions at 12-13).

The OCA replied that it would be improper to include capitalized labor in rate base for non-existing employees (OCA Reply Exceptions at 12).

[15] Based upon our earlier discussion, we will adopt, in principle the recommendation of the ALJ insofar as he accepted the percentage of capitalization. We reject as unsupported, the argument of NFGD regarding the use of outside contractors. We will modify the OTS adjustment which was accepted by the ALJ only to reflect our change of the payroll complement from 496 to 501. Adjustment for this change amount in the reduction of the adjustment to rate base of $ 52,088, amounting to a total rate base adjustment of $ 604,217. Additionally, the associated depreciation expense, and accrued depreciation expense adjustments decrease to $ 18,733 and $ 9,367 respectively, based upon the calculations which appear at page 77 of the Recommended Decision, and supra, herein.

6. Inflation adjustment

Both the OTS and the OCA recommend the disallowance of the Company's inflation expense which is a separate adjustment of 2.58% to seventeen cost elements that are not otherwise adjusted. OCA M.B. at 117-123, OTS M.B. at 91-96. Both parties oppose this inflation adjustment because it is used in place of any actual anticipated and measurable price changes and would serve to institutionalize inflation. OCA M.B. at 118.

In its Main Brief, the Company contends that the OCA and the OTS oppose its inflation adjustment in its entirety "despite the fact that inflation adjustments in rates cases are so routine it is difficult to find a rate, case in which any party proposed total disallowance of inflation adjustments." NFGD M.B. at 76-77.

The ALJ commented that the fact that a particular adjustment is "routine" is not a compelling reason to allow an unsubstantiated claim. The ALJ cited

Lower Frederick Twp. Water Co. v. Pennsylvania Pub. Util. Comm'n, 48 Pa. Cmwlth. Ct. 222, 409 A.2d 505 (1980) for the proposition that it is the Company's burden to prove each element of its rate request with convincing and substantial evidence. The ALJ continued that the Company's desire to continue a "routine" practice was best exemplified by the testimony of NFGD witness Higley who stated that the inflation factor was applied because it was "easier" than doing a detailed analysis of the cost elements. N.T. 355. Both the OTS and the OCA submit that this lack of analysis and substantiation of a claim cannot be accepted. OCA M.B. at 119, OTS M.B. at 92.

The OCA discusses at length the inherent flaws of a blanket inflation adjustment. OCA M.B. at 121-122. The OCA argues that an inflation adjustment has no regard for actual experience and violates the future test year concept of creating "typical" expenses. OCA M.B. at 121. The Commission has specifically held that inflation adjustments do not create known and measurable changes because not all expenses are affected by inflation and those that are affected by inflation experience inflation differently. The OCA cited Pennsylvania Pub. Util. Comm'n v. Pennsylvania American Water Company, 71 Pa. PUC 210, 269 (1989), for the proposition that costs do not move in a synchronized manner and therefore inflation factors would serve to overstate or understate actual price escalation that will be experienced.

The OCA continued that the data provided by NFGD on the trends in price variations for the seventeen items adjusted for inflation demonstrated the inaccuracy of the inflation adjustment. A tracking of all of the cost elements over the past several years reveals that changes in individual expenses do not approach a pattern and do not justify a blanket adjustment. OCA M.B. at 122. The OCA claims that the Company attempted to show there is an average increase in actual expense levels over a four year period for all of the cost elements.

Id. However, the OCA argues that the average of all items presented by the Company hides the dynamic nature of price and activity changes. Specifically, the OCA contends that on an item-by-item basis, there are both increases and decreases in cost levels over time. OCA M.B. at 121-122, OTS M.B. at 91.

Further, the OCA argues that the Company's inflation adjustment ignores that other cost elements, such as equipment rentals, may be governed by long term contracts. OCA M.B. at 122. The OCA pointed out that the Company witness sponsoring this adjustment could give no specific details about contracts that govern equipment rentals. Id. Again, it is the opinion of the OCA and the OTS that the Company believes that it is "easier" to just apply a blanket inflation factor instead of determining a reasonable level of expense for each cost element.

The ALJ proffered the following resolution of this issue:

The Company's 2.58% adjustment to the seventeen cost elements should be rejected as unreasonable and unsubstantiated. The resultant OCA adjustment is $ 442,000. OCA M.B. at 123; OCA St. 3 at 70-72, Sch. 11. This OTS adjustment is reflected as a $ 430,000 expense disallowance because it has previously disallowed the $ 12,000 rate case expense inflation adjustment in its rate case expense proposal. OTS M.B. at 92; OTS St. 2 at 42. We recommend the adoption of the OCA's adjustment of $ 442,000. (R.D. at 80).

In its Exceptions, NFGD argues that each category of expense to which the inflation adjustment is applied actually increased during the 5-year period ended November 30, 1993 and that such excess increased overall at a rate that exceeded the inflation rate. Therefore, concludes NFGD its inflation adjustment is conservative. (NFGD Exceptions at 20).

The Company addresses the criticism of the ALJ and the OCA that NFGD failed to prove that each cost component subjected to the inflation adjustment marched in perfect lock step with inflation. The Company continued that such a requirement is not realistic, and certainly not been met in any of the many cases in which the Commission has approved inflation adjustments in recent years. (Id.)

Finally, the Company criticizes the ALJ's reliance on Pa. P.U.C. v. Pennsylvania-American Water Company, 71 Pa. P.U.C. 210, 267-69 (1989). According to NFGD, in that case, the Commission did not reject an inflation adjustment, but rejected the utility's proposal to apply 18 months of inflation to historic test year levels to adjust expenses to the level at the end of the future test year. The Commission instead permitted a 12-month adjustment, exactly as NFGD has proposed in this proceeding. (NFGD Exceptions at 21).

In its Reply Exceptions, the OTS reiterates that the Company failed to meet its burden of proof on this adjustment due to the arbitrary nature of the Company's adjustment. Specifically, according to the OTS, NFGD arbitrarily adjusted 17 O&M expense items without making any effort to determine whether or not the expenses were inflation sensitive. (OTS Reply Exceptions at 13).

The OCA in its Reply Exceptions, asserts that it had never argued, nor did the ALJ require that every cost item be in perfect lock step with inflation. The OCA argued that the adjustment is unsupported, and that the fact that inflation adjustments have become almost "routine" is not a compelling reason to allow an unsubstantiated claim for inflation. (OCA Reply Exceptions at 13).

[16] Based upon our consideration of the positions of the parties, we do not find that the

arguments contained in the Company's Exception rise to a level that would cause us to reverse the ALJ's resolution of this issue. We agree that the Company's adjustment is unsubstantiated. Based upon the foregoing discussion, we will deny the Company's Exception regarding this issue.

8. Advertising

The ALJ began his discussion of this issue by noting that under Section 1316(a) of the Code, 66 Pa. C.S. § 1316(a), advertising expenses are recoverable if they meet at least one of the following criteria:

(1) Is required by law or regulation.

(2) Is in support of the issuance, marketing or acquisition of securities or other forms of financing.

(3) Encourages energy independence by promoting the wise development and use of domestic sources of coal, oil or natural gas and does not promote one method of generating electricity as preferable to other methods of generating electricity.

(4) Provides important information to the public regarding safety, rate changes, means of reducing usage or bills, load management or energy conservation.

(5) Provides a direct benefit to ratepayers.

(6) Is for production of community service or economic development. (R.D. at 80-81)

At pages 47-53 of OCA Statement No. 3, the OCA proposes to disallow a substantial portion of Distribution's advertising expense. In making this proposed adjustment, the OCA would eliminate, for ratemaking purposes, advertising which it considers to be competitive in nature.

The Company argues that its advertising programs have not changed substantially over the years and therefore, since neither the OTS nor the OCA have challenged the advertising in three of the last four litigated rate cases, we may look to those for instruction. NFGD M.B. at 81.

In the earliest of the three recent cases in which the Commission addressed advertising issues, Pa. P.U.C. v. National Fuel Gas Distribution Corp., 62 Pa. P.U.C. 407, 421-22 (1986), the Commission considered conservation advertising emphasizing high efficiency gas appliances. The Company argues that the Commission found specifically that advertising efficient gas appliances meets criteria three and four by promoting wise use of domestic natural gas and provides important information concerning means of reducing usage or bills. NFGD continued that the Commission also noted that the cost of the advertising program amounted to only a small amount per customer per year so that only a small amount of conservation resulting from the advertising would justify the advertising expense. The Company proffers the following cite from the aforementioned case: We find that the evidentiary nexus between the conservation appliance commercials and sufficient customer benefit is strong enough to justify the relatively modest expense involved.

Pa. P.U.C. v. National Fuel Gas Distribution Corp., 62 Pa. P.U.C.,

supra, at 422.

NFGD discussed the next Commission proceeding wherein its advertising program was considered, Pa. P.U.C. v. National Fuel Gas Distribution Corp., 67 Pa. P.U.C. 264, 307-09 (1988). NFGD cited that particular Opinion and Order as follows: Distribution's efficient appliance advertising promotes prudent use of natural gas supplies and provides customers with information about ways to reduce gas usage. In addition, to the extent that such advertising reduces conversion by customers to appliances and equipment that use other forms of energy, such as electricity or oil, such advertising helps to preserve Distribution's sales volumes with consequent benefits to customers because of loss of revenues and load would mean that higher fixed costs would have to be borne by Distribution's remaining customers. . . . . In conclusion, we find that the Company's claim for advertising appliances does provide a direct benefit to ratepayers since such advertising, in addition to encouraging energy conservation, aids the Company in maintaining or improving load.

Pa. P.U.C. v. National Fuel Gas Distribution Corp., 67 Pa. P.U.C., supra, at 308-09.

The Company continues that issues concerning advertising were raised again in

Pa. P.U.C. v. National Fuel Gas Distribution Corp., 73 Pa. P.U.C. 552, 582-583 (1990). There, OTS had objected to an increase in Distribution's annual level of advertising expense. The Company cited the Opinion and Order at page 582, as follows: We are not persuaded by the OTS' argument that the ALJ was incorrect in finding Distribution's projected expense for conservation advertising to be reasonable. Energy conservation on the part of all customers should be encouraged, and getting the message to them through advertising certainly helps in achieving that goal. In the context of this proceeding, the Company's conservation advertising claim is cost effective and of a direct benefit to ratepayers, as noted by the ALJ. We adopt the ALJ's recommendation and the OTS' Exception is denied.

However, the OCA submits that the case cited in its Main Brief involving Equitable Gas Company provides the Commission's most instructive and pertinent insight on the treatment of promotional activities in rates. See

Pennsylvania Pub. Util. Comm'n v. Equitable Gas Company, 73 Pa. PUC 301 (1990); OCA M.B. at 84; 86-89 ("Equitable"). The OCA submits that specifically, the Commission determined in that 1990 case, that Equitable's cooperative advertising and promotional allowances (which are the same types of promotional activities engaged in by NFGD) did not meet any of the requirements of Section 1316 of the Code. Id., 73 Pa. PUC at 320. The OCA continues that the Commission emphasized that these types of activities do not benefit residential customers in particular. Id. Specifically, the OCA proffers the following cite from Equitable in support of its contention that the Commission concluded that cooperative advertising and promotional allowances benefit the developers, builders and realtors and not the ultimate customer: Therefore, it is apparent that the gas company with which a developer or builder engages in cooperative advertising is likely to be the gas company to which the home buyer will be connected for the duration of his or her ownership. The builder or developer may not choose a gas company on the basis of rates or service to the homeowner, the ultimate customer, but may choose a gas company on the basis of the size of the promotional allowance or advertising allowance offered. Thus, the cooperative advertising benefits the developer, the realtor, or builder, but not necessarily the ultimate ratepayers.

Id. (emphasis, added).

The ALJ stated that the Commission in Equitable held that cooperative advertising and promotional allowances are particularly detrimental to residential customers who are captive customers. The cited Equitable as follows: To the extent that Equitable provides promotional allowances to developers or realtors, or shares advertising costs with developers or realtors, those parties may or may not pass on the amounts obtained from Equitable to their customers in the form of reduced housing costs . . . . We hasten to point out that residential ratepayers are basically captive ratepayers. While large industrial and commercial customers have some ability to switch LDCs . . . , and while some residential ratepayers have the ability to switch LDCs . . . , most residential ratepayers when connected to a gas line do not have a sufficiently large load to attract the interest of a competitive gas company.

Id., 73 Pa. PUC at 319 (emphasis added).

The ALJ continued that the Commission in Equitable was not convinced that competition justified these kinds of promotional activities. Again, said the ALJ, the Commission stressed that cooperative advertising and promotional allowances were "absolutely indefensible when used to attract or retain residential ratepayers who . . . are largely captive ratepayers." Id., 73 Pa. PUC at

327. The ALJ then cited Equitable as follows: While Equitable regards Duquesne Light and fuel oil companies as being its competitors . . . , the bulk of Equitable's competition is with other LDCs . . . . While it is true that by adding additional customers, Equitable, and its ratepayers, benefit by having a larger customer base over which to distribute fixed costs, that benefit simply comes at the expense of the other LDCs in the western Pennsylvia area and their ratepayers . . . . The ALJ observed that this kind of "competition" merely serves to "rob Peter to pay Paul." . . . . Furthermore, to the extent that Equitable expects to recover the cost of these promotional allowances from its ratepayers (as do all the other LDCs), these payments simply serve to raise the cost of service to all of the Western Pennsylvania ratepayers.

Id. (emphasis added).

The OCA commented that what is particularly egregious about NFGD's promotional activities is the fact that the Company does not, in fact, face real competition for most of its load. The OCA observed that NFGD has admitted that it holds the vast majority of the energy market in its service territory and that electric competition is de minimis. OCA M.B. at 81-82.

The OCA argues that the Company cites at length past cases wherein the Commission has permitted NFGD to recover the costs of "conservation advertising." See NFGD 1986, supra; NFGD 1988,

supra; NFGD 1990, supra. The OCA counters that, while it is true that the Commission permitted the recovery of conservation advertising expense, it did not have to address the Company's contention that its frequent rate case filings are due, in part, to the effects of these very "conservation" programs. OCA R.B. at 40. It is ironic, according to the OCA, that while NFGD witness Sprague represents these promotional activities as programs that encourage the efficient use of natural gas that will directly benefit Distribution's customers, Company witness Wright complained that these programs cause a decrease in sales load and is one factor that leads to NFGD's frequent rate increase requests. NFGD St. 219 at 4. The OCA argues that if NFGD's promotional programs do, in fact, promote conservation and if NFGD's witnesses are to be believed, customers ultimately have to pay higher rates to make up for the decreased sales load caused by energy efficiency. The ALJ presents a cite from Mr. Wright's testimony as follows:

Q. Now is it your testimony then that the result of encouraging gas efficiency would be another factor that necessitates frequent rate filings or higher rates to customers?

A. It would be my testimony that whenever somebody replaces an old appliance with a new appliance, all things being equal, the new appliance is more efficient, causing the customer to use less gas, causing sales to decline when one would compare them to prior usage.

Q. And as a result, the fixed costs that Distribution needs to recover from those customers must be spread over a lower volume, correct?

A. The denominator would definitely be lower. R.D. at 86-87.

The OCA continued that Mr. Wright also agreed that the cost of providing such programs is another factor that would add to increased costs for which NFGD would file for rate relief. The OCA submits that he further agreed that these programs to promote efficient use of gas could be one of the reasons NFGD has to raise its rates since it must spread its fixed costs across a smaller customer base. N.T. 1031. Specifically, Mr. Wright explained as follows:

Q. Now, in addition to the fact that these programs cause decreased gas usage, which means recovering less money because of lower volumes consumed by customers, there's a cost incurred by the company, isn't that true, Mr. Wright, to provide these programs?

A. That's true.

Q. And that would probably be another factor contributing to the need for higher rates due to higher costs incurred by Distribution?

A. That's true.

Q. Now, using that analysis, if NFG were permitted to recover those costs in rates, of providing these programs, and if, in fact, customers consumed less gas because they were using energy more efficiently, customers might still pay higher rates to pay for higher costs, that you say NFG is incurring, spread across fewer billing units?

A. That might be the case. N.T. 1031-1032.

The OCA submits that certainly, it would be difficult to justify allowing the recovery of so-called energy efficiency programs that NFGD essentially promises will result in higher rates to its customers. Additionally, in light of the public input testimony regarding the impact of increased gas rates upon customers, this expense is simply not warranted.

Furthermore, the OCA points out that the Commission has had recent occasion to address the cooperative advertising program of another utility.

Pennsylvania Pub. Util. Comm'n v. UGI Utilities, Inc., R-00932862, slip op. (July 25, 1994) ("UGI 1994"). In the UGI 1994 case says the OCA, the Commission disallowed the costs associated with the Company's cooperative advertising program because it could glean no direct benefit to UGI's ratepayers. Id., slip op. at 74. The OCA continued that the Commission concluded that the benefit runs to the contractors and the utility's shareholders, and not the ratepayers. Id. OCA. R.B. at 42.

The ALJ made the following disposition of the advertising expense issue: While NFGD argues that OCA's reliance on UGI 1994 is misplaced, we believe that the underlying rationale is indicative of the Commission's concerns to move away from advertising which does not benefit the ratepayer directly.

The OCA submits and we agree that NFGD's claim for promotional activities cannot be justified under Section 1316 of the Public Utility Code or by Commission precedent. Therefore, NFGD's $ 549,314 claim should be disallowed. (R.D. at 88).

In its Exceptions, the Company argues that the ALJ erred in recommending rejection of its claim for advertising expenses despite the fact that the Commission had determined in three previous decisions wherein this expense claim was challenged that NFGD's advertising conformed to the standards articulated in Section 1316(a) of the Code. On page 22 of its Exceptions NFG proffers a cite from each of the three proceedings wherein its claim for operating was adopted. The Company repeated that in previous proceedings, the advertising programs were similar to that proposed in the instant matter.

The Company criticizes the ALJ's reliance on Pa. P.U.C. v. Equitable Gas Co., 73 Pa. P.U.C. 301 (1990). The Company argues that Equitable is inapposite because it predated the Commission's most recently expressed approval of the Company's advertising program by one month. The Company argued that the distinctions between its program and that of Equitable in that NFGD'S competitors in the residential market include electricity, oil and propane, while Equitable's main source of competition was other gas companies. NFGD continues that it can show that a public benefit to its advertising because the cost of water and space heating from gas is less than the cost of same by electricity, oil or propane. According to NFGD, Equitable was unable to show a public benefit of its advertising because its rates for gas service were higher than the rates of the other gas companies. Thus, NFGD avers that Equitable, through its advertising, was encouraging people to pay more, not less, for the same service. (NFGD Exceptions at 23).

Another distinction between the instant proceeding and Equitable, continues NFGD is that Equitable's advertising program was not entered into evidence in that proceeding. NFGD argues that here, it produced its entire advertising program. NFGD adds that there was no criticism of any advertisement as being improper under the statutory standards. Instead, claims the Company, the advertisements are dismissed as being competitive or cooperative. The Company submits that a review of its advertising program would reveal that the portion thereof at issue clearly explains the advantages of natural gas as opposed to other energy, or identifies particularly efficient gas appliances. (NFGD Exceptions at 24).

The Company excepts to the ALJ's statement wherein he criticized its advertising program as being unnecessary because NFGD has been successful in retaining most of its load. The Company asserts that such criticism misses the point that NFGD faces competition in the residential market. NFGD continues that each year thousands of gas appliances are replaced, and that each replacement is a decision by a customer. Thus, the Company argues that when these decisions are made, the customer should have available information concerning the benefits of natural gas. NFGD contends that its message is fair and accurate because natural gas is economically advantageous to customers. Further, NFGD asserts that it is not in the customers' interest to continually hear advertisements for other forms of energy, while the company stands mute. NFGD concludes that its competitors pay more for advertising than does the Company. (NFGD Exceptions at 24).

The Company counters the ALJ's conclusion that NFGD's advertising promoting conservation may result in a rate case. The Company characterizes such criticism as misdirected. NFGD maintains that although conservation may contribute to a base rate proceeding, conservation will not, of itself, cause customers to pay more. The Company asserts that the result of conservation is that base rates must be increased to produce the same level of recovery of fixed costs prior to conservation efforts. Therefore, NFGD claims that higher base rates may be needed to produce the same level of dollars, not additional dollars. The Company concludes by stating that base rate increases can be offset by savings in purchase gas resulting from reductions in usage. Thus, in this matter, says NFGD, conservation could result in lower total bills to customers. (NFGD Exceptions at 25).

The Company criticizes the ALJ's reliance on Pa. P.U.C. v. UGI, docketed at No. R-932862 (Order entered July 25, 1994). According to the Company the ALJ's reliance on UGI is misplaced because UGI's advertising, which was rejected by the Commission, was "patently a promotional effort intended to enhance housing contractors' sales [of homes]" UGI at 73. The Company concludes that its cooperative advertising places information where the selections among gas, electric or oil equipment and between higher and lower efficiency appliances are made (NFGD Exceptions at 25-26).

In its Reply Exceptions, the OCA pointed out that expense disallowances of $ 549,314 in advertising expenses associated with 5 specific programs were disallowed. The OCA continued that these specific programs were targeted at appliance dealers, heating and plumbing contractors, and building architects/engineers. Moreover, the OCA asserts that it identified $ 19,600 in cash payments to commercial and industrial customers in direct violation of the Commission's regulations at 52 Pennsylvania Code, Chapter 57 Section 61, 52 Pa Code, § 57.61. The OCA continues that Equitable and UGI stand for the proposition that the Commission is moving away from advertising that does not directly benefit the ratepayer. Moreover, the OCA asserts that the Commission has indicated its concern that advertising not be utilized for the purpose of competing for new or existing load. (OCA Reply Exceptions at 15).

The OCA argues that there is very little to distinguish its claim from Equitable's. Further, says OCA, in comparison to Equitable, NFGD has relatively little competition for load. Further, argues the OCA, NFGD has 93.7% of the residential market for space heating in its service territory and 96% of the commercial market. Thus, OCA insists that the Company is the dominant supplier of space and water heating in its service territory. The OCA concludes that NFGD's advertising does not provide a direct benefit to ratepayers pursuant to Section 1316 of the Code. (OCA Reply Exceptions at 16).

The OTS, in its Reply Exceptions, stated that in the event that the Commission grants any part of the Company's claim for advertising expense, it should, at a minimum, disallow the portion of the advertising expense, in the amount of $ 40,791, identified by Mr. Maher as the Competitive Response Program. (OTS Exceptions at 14).

[17] After our careful consideration of the positions of the parties, we will adopt the reasoning and recommendation of the ALJ on this issue. We found the Company's argument that its advertisement regarding the efficiency of natural gas vis-a-vis other energy sources is beneficial to the ratepayer, to be unconvincing. We found, in fact, that the Company's advertising is in essence targeted to seek and retain load. We find that the advertising program of NFGD does not meet the statutory requirements of Section 1316(a) of the Code. Based upon the foregoing discussion we will deny the Company's Exception.

9. Uncollectible accounts expense

9(a). Recovery Of Pre-Program LIRA

NFGD witness Thomas Ring developed the Company's revised uncollectible accounts expense claim of $ 3,323,514 n13 (exclusive of the Sharon Steel and Franklin Steel amortizations) using a ratio of historic (July 1991 to June 1994) net write-offs (write-offs less recoveries) to revenues. The net write-offs are comprised of final bills which are twelve months old. NFGD Stmt. No. 207, p. 3; NFGD Ex. No. 104-A-2, p. 1 (update as of July 19, 1994). NFGD explained that the ratio of historic net write-offs to revenues is then applied to projected future test year revenues to calculate the uncollectible accounts expense for ratemaking purposes. NFGD Stmt. No. 207, p. 3.

The ALJ observed that for the first time in developing its uncollectible accounts expense claim, NFGD has included $ 534,434 in Low Income Residential Assistance (LIRA) n14 pre-program arrearages in historic net write-offs (for May 1993 - June 1994). OTS Stmt. No. 2, pp. 2-3; OTS Ex. No. 2A, Sched. 1 (revised); N.T. 794. See late-filed exhibit OTS Ex. No. 2A, Sched. 1 (revised) for updated NFGD uncollectible accounts expense claim.

OTS witness Mr. Maher proposed an adjustment to NFGD's uncollectible accounts expense claim to remove the LIRA pre-program arrearage write-offs from the calculation. OTS Stmt. No. 2, pp. 2-3. The position of the OTS is that inclusion of these "forgiven" arrearages in uncollectible accounts expense to be recovered from other ratepayers is not appropriate. OTS M.B. at 30. The OTS submits that while NFGD contends that the arrearage forgiveness aspect of its LIRA program was approved by the Commission as a part of the Company's CAP program, the Company has provided no evidence of Commission authorization to collect these forgiven arrearages from other ratepayers. NFGD Stmt. 207, pp. 2-3; N.T. 968. OTS M.B. at 30.

The OTS cites Pa. P.U.C. v. Columbia Gas of Pennsylvania, Inc., R-901873, Order entered October 31, 1991, ("Columbia 1990"), for the proposition that the Commission has previously denied recovery of forgiven CAP arrearages to utilities because to allow recovery would constitute retroactive ratemaking. The OTS' rationale for eliminating the arrearages forgiven under the LIRA program is provided at page 3 of OTS Statement No. 2 as follows: 1) [T]hey represent arrearage forgiveness, which has previously been rejected by the Commission as retroactive ratemaking, at Pa. P.U.C. v. PECO, Docket No. R-891364 and Pa. P.U.C. v. Columbia Gas, Docket No. R-891468; 2) any benefit of lower uncollectible accounts expense due to the LIRA program is defeated by increasing the net write-offs with pre-program arrearages.

NFGD's witness Mr. Ring noted that the Commission decision in Pa. P.U.C. v. Columbia Gas of Pennsylvania, R-891468, Order entered September 20, 1990, ("Columbia 1989") was reversed by the Commonwealth Court at 613 A.2d 74 (1992), and this reversal was affirmed by the Pennsylvania Supreme Court at 636 A.2d 627 (1994). NFG continued that in Columbia Gas of Pennsylvania, Inc. v. Pa. P.U.C., 149 Pa. Commonwealth Ct. 247, 613 A.2d 74 (1992), aff'd, ___ Pa. ___, 636 A.2d 627 (1994), ("Columbia 1992"), Columbia Gas challenged, among other things, the Commission's disallowance of recovery of uncollectible arrearages that had arisen under a Commission-mandated program for assisting payment-troubled customers. The Commonwealth

Court's discussion of the issue is provided at Columbia Gas, 149 Pa. Commonwealth Ct. 247, 613 A.2d at 79-80:

The only issue, therefore, is whether allowing the full claim now violates the principle of retroactive ratemaking. In our view, several factors distinguish this situation from that discussed above relating to the untimely claim for the York plant investigation expenses. Columbia emphasizes that it adopted and actively pursued the use of the budget plus program only pursuant to the direction of the Commission, and that the program disputed the workings of the normal termination and bad debt recovery procedures that were in place before.

The Commission did not order Columbia to incur a direct expense, for example, by ordering necessary repairs. Rather, the Commission ordered Columbia to adopt billing and termination procedures that ultimately created increasingly large arrearages and at the same time prevent Columbia from terminating service and writing them off as uncollectible. At the time of the two intervening rate cases, Columbia had no reason to seek to recover as uncollectible the arrearages claimed here, because it was complying with the PUC's direction to maintain them as accounts receivable. It was not until 1989, when the auditors informed Columbia that some of the accounts were not properly designated as receivable, that Columbia's duty was triggered to seek to terminate service and write off the accounts or to seek an assured method of payment. The money Columbia seeks to recover now as an expense definitely became owing in the past; however, under the peculiar circumstances of this case, the present rate proceeding is the first time that Columbia had an opportunity or a reason to seek recovery of that money in rates. We reverse the Commission's denial of recovery of the full $ 4.5 million.