

National Fuel

Anna Marie Cellino
President

June 12, 2009

Honorable Jaclyn A. Brillling
Secretary
Public Service Commission
Three Empire State Plaza
Albany, NY 12223-1350

Re: Case 09-M-0435 - Proceeding on Motion of the Commission Regarding
The Development of Utility Austerity Programs

Dear Secretary Brillling:

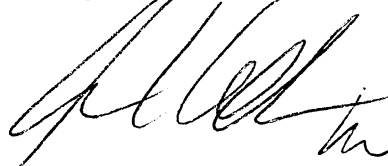
In response to the Notice issued in the above-referenced proceeding on May 15, 2009, National Fuel Gas Distribution Corporation (“Distribution” or “Company”) submits the attached Report and proposal for voluntary bill credits in the amount of \$6.2 million, equal to 5.03% of the Company’s operations and maintenance expense, for the Commission’s review and consideration.

Coupled with the lowest gas supply prices since 2002, the Company’s proposed bill credits can help to drive customer bills lower than they were at the same time last year, even with the addition of dramatically higher utility taxes recently enacted by the state legislature. As more fully detailed in the Report, the proposed bill credits are made possible by a combination of tax refunds and spending cuts initiated by Distribution in the course of business and in direct response to the Notice.

Distribution acknowledges the Commission’s deep concern for utility customers during these difficult times and believes that the proposals submitted in its Report are fully responsive to the Notice. We are prepared to implement the proposed bill credits in the various methods presented, or as otherwise requested by the Commission, on an expedited basis if necessary.

Thank you for your attention to this matter.

Respectfully submitted,



STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 09-M-0435 - Proceeding on Motion of the Commission Regarding the
Development of Utility Austerity Programs

REPORT OF
NATIONAL FUEL GAS DISTRIBUTION CORPORATION
IN RESPONSE TO NOTICE

On May 15, 2009, the Public Service Commission issued a Notice in the above-captioned proceeding directing utilities to file a report that “should detail the actions taken by the utility since September 2008 . . . to respond to the need for austerity and to advise the Commission of the utility’s plans for austerity in the future,” among other things (“Notice”). For its response to the Commission’s Notice, National Fuel Gas Distribution Corporation (“Distribution” or the “Company”) submits the instant Report.

As outlined in this Report, Distribution proposes to credit customers’ bills approximately \$6.2 million, an amount equal to, for illustration purposes, nearly 5.03% of the Company’s operation and maintenance expense currently in rates.¹ As explained below, these bill credits would result from the following measures: reducing capital spending, reducing operation and maintenance expense, reasonable spending cuts in the Company’s conservation and efficiency program and an accelerated return of previously-collected taxes. The Company is also asking the Commission to consider a proposal to restore a fixed price option for utility supply service to provide customers with another means of managing household energy costs.

¹ The credit, as more fully described below, would be funded from a combination of sources.

Preliminary Remarks

Distribution is keenly aware of the current economic environment. As the Commission correctly notes, the downturn “has dramatically affected many residents and businesses in New York State.” As a major corporation and employer headquartered in western New York, the Company, its affiliates and its employees are also affected by the recession, as are all of Distribution’s contractors and vendors, especially those located in western New York. At the same time, however, significant relief is already being conferred on customers because gas bills are down due to reduced supply costs. So the notion that immediate relief is needed must be viewed in light of the fact that immediate relief has already been forthcoming – and it is relief of a magnitude that is far greater than would be possible even from draconian cuts in services and construction spending.

Further, Distribution, itself, is hardly immune to an economic downturn. Distribution’s parent, National Fuel Gas Company (“National”), has seen the market value of its stock value fall from a high of over \$62.00 per share in July 2008, to approximately \$36.00 per share (as of June 10, 2009). This represents a reduction in National’s market capitalization of more than \$2.06 billion.

Distribution’s employees, too, are deeply affected by the drop in National’s share price and earnings as well as the precipitous drop in the overall equities market. Most of Distribution’s employees are also shareholders through the Company’s “401(k)” plan. If National’s share price has fallen, then Distribution’s employees’ 401(k) retirement funds have lost value.

Distribution’s executives receive stock-based compensation and incentive pay tied to earnings performance. Following the market, the value of the executives’ stock-based

compensation has declined. With National's earnings expectations already down compared to prior projections, the executives' earnings-based compensation itself is also expected to fall.

More important, beginning well prior to the Notice, National and Distribution adopted aggressive cost-saving measures on their own in the ordinary course of business. In the case of Distribution, these measures were further necessitated by the Commission's order in the Company's most recent rate case decided on December 21, 2007.² In that proceeding, Distribution sought permission to increase its base rates (after adjustments) by approximately \$37 million. The Commission, however, approved a rate increase of \$1.8 million. In order to continue safe and adequate service and deliver financial results expected by the investment community, the Company was forced to cut costs.

Unlike its downstate counterparts, Distribution's primary means of protecting earnings outside of a rate case is cutting expenses. This is because Distribution's western New York service territory is fully mature, with no growth and almost 100% saturation of the space heating market. As a result, the Company is simply unable to safeguard a reasonable level of earnings by growing its customer base through conversion of oil burning customers to natural gas service. Instead, the Company has consistently controlled its operating costs.³

Although Distribution does not challenge the Commission's statement that the "downturn in the national and state economy has dramatically affected many residents

² Case 07-G-0141, National Fuel Gas Distribution Corporation, Order Establishing Rates for Gas Service (issued December 21, 2007) ("2007 Rate Case").

³ The Company has made a substantial investment in distribution main lines in order to achieve its high level of market saturation. Due to the size of Distribution's service territory, in order to meet its franchise obligations the Company has invested an average of 97 feet of mainline per customer, compared to the state average of 53.5 feet per customer. In other words, Distribution has invested approximately 81% more in pipeline infrastructure per customer than the average New York gas distribution utility.

and businesses in New York State,” the Company notes that its billed rates are actually down when compared to bills issued twelve months ago. Residential bills for the period November to March of 2008, based on normalized volumes, averaged \$1,077. For the same period in 2009, the average bill, also based on normalized volume, was \$1,046.⁴ Likewise, the Company projects that customer bills in the coming months will also be significantly lower than last year’s bills. Based on recent NYMEX forward prices for the upcoming winter, bills are forecast to be 16% lower than last winter.

Furthermore, Distribution’s delivery charges have held steady since its last rate award in December 2007, and the Company does not have a rate case on file at this time. Although non-discretionary costs are up or projected to rise, the Company has no current plans to file a general rate case. So unlike the situation confronting customers of other utilities that recently received or are expected to receive rate increases,⁵ Distribution’s customers are not facing an increase in delivery charges beyond the increase in the state-mandated Public Service Law §18-a utility assessment. While this does not suggest that the austerity adjustment recently imposed on Consolidated Edison in response to its rate increase reflects sound ratemaking policy, we believe that it certainly undermines, significantly, the Commission’s rationale supporting the adoption of similar austerity measures for Distribution.

The very reason why Distribution has avoided filing for a rate increase since 2007 is because it is motivated to control its costs in response to the natural incentive arising from “regulatory lag.” Regulatory lag is the time period between rate awards during

⁴ Average total bills based on actual volumes were roughly equal.

⁵ Indeed, customers of some utilities – not Distribution – have received a number of rate increases recently in seriatim. While this fact does not justify forced “austerity” credits for those utilities, it nonetheless distinguishes Distribution’s customers from the customers of other utilities.

which utility management cuts certain costs to counteract the increase in other costs or infrastructure investment. Interrupt regulatory lag by, for example, passing back savings generated between rate cases, and the utility is forced to file for another rate increase sooner rather than later. Nobody likes a rate case – not the utility, not the Commission, and certainly not the public - and so in times of increasing costs, like now, it is presumably incumbent on utilities to undertake efforts to *avoid* rate cases, if at all possible. To “share” savings – whether from cost cutting or postponement of necessities – with customers between rate cases is the ratemaking equivalent of a utility increasing its spending between rate cases. Both practices would end with the same result – another rate case.

In light of the foregoing considerations, Distribution believes that it is inconsistent with public policy to seek from utilities the pass-through of savings generated by the efforts of management to avoid the need for a rate increase. If utilities engaged in cost-cutting measures in response to the economic downturn, that effort was not initiated for the purpose of passing the resulting savings back to customers. Rather those cost-cutting measures were likely designed to preserve cash in a credit-constrained environment or to maintain earnings, to the extent possible, within projected levels. These are actions that prudent utilities undertake to *avoid* rate increases. Capturing those savings now to reduce utility rates defeats their very purpose.⁶

⁶ This is precisely why the utility companies identified by the Commission in footnote no. 596 of its order setting rates for Consolidated Edison engaged in the “austerity” measures listed. Case 08-E-0539 et al., Consolidated Edison Company of New York, Inc., Order Setting Electric Rates (issued April 24, 2009). For example, American Electric Power (“AEP”) cut its capital spending budget by \$750 million in order to reduce the company’s need to access uncertain capital markets in 2009. If AEP were directed to flow the resulting savings back to customers, AEP would be forced back into those unpredictable capital markets, defeating the purpose of its austerity measure.

In this regard, Distribution has a long and successful history of holding down its costs in order to maintain reasonable delivery rates. The success of these efforts can be seen by comparing the change of expense levels since September 1996. Total O&M expenses of Distribution's New York division for the twelve months ended September 1996 were \$149,324,000. As of March 31, 2009, O&M expenses were \$129,846,000. If the Company had merely allowed the general inflation experienced in the U.S. to likewise increase its O&M expenses, the \$149,324,000 of O&M expense in September 1996 would have grown to \$197,142,000 by March 2009, an outcome avoided by the Company's cost-containment efforts.

The Company has achieved much of these savings by focusing on continuous, careful spending measures on labor and productivity. In 1996, Distribution had 1,671 employees serving approximately 500,000 customers. As of April 2009, Distribution had 1,003 employees – a reduction of 40% -- serving approximately the same number of customers in a far more complex regulatory environment.

In addition to cutting the number of employees, Distribution has aggressively managed its employee benefit costs. Pension costs are a major expense, owing to the number of employee participants in the benefits plans and the Company's large number of retirees. In order to slow the growth in pension expense, the Company closed its pension plan to new employees hired after July 2003. In its stead, a more stable and ultimately less costly defined contribution plan was established. Although savings from this action will be relatively minor at first, over the long run as the workforce continues to turn over those savings will grow.⁷

⁷ Savings in pension costs are automatically captured for the benefit of ratepayers through the Commission's generically-adopted pension deferral mechanism.

The Company applies its cost-containment practices where it can. Many of Distribution's increasing costs, however, are beyond the control of management. A notable example is the recent amendment to Section 18-a of the Public Service Law, which dramatically increases the utility assessment. For Distribution, this change will increase the assessment expense level from \$2.4 million to over \$26 million, an amount in excess of any single rate increase approved for Distribution at any time in the past thirty years. Distribution has no control over the size of the assessment inasmuch as it is a tax imposed on utilities by the legislature.

The Company's O&M costs are also under constant upward pressure by numerous programs and services adopted by the Commission and imposed on utilities in recent years. While these programs may improve customer service or otherwise serve the public interest, they also increase costs. A leading example is retail customer choice, which did not exist at all for small customers prior to 1996, and has grown dramatically during the past five years. Labor, information systems, billing, customer care, dispatching and legal resources, among other operations, are dedicated to managing the customer choice function for energy service companies in compliance with Commission requirements. Even though utility infrastructure and utility employees enable the services that support retail competition, management has little control over the provision of those services, and as a result is unable to make sizable cuts.

Another source of rising expense is service quality and safety performance mechanisms. These mechanisms set service performance targets that are ostensibly designed to improve customer service or pipeline safety without reference to any

objective level of service. While these programs might arguably produce customer value, they also increase costs. Although management can and does undertake efforts to control the cost of the functions subject to these performance mechanisms, that discretion has its limits because ultimately, the mechanisms are required whether they are cost-effective or not.⁸

Distribution's ability to significantly reduce its capital budget is extremely limited. The Company has been careful with respect to capital spending for years, and its annual capital budget has declined approximately 30% in the past decade due to carefully targeted replacement programs and aggressive cost control. This already leaves little room for further, meaningful cuts. At least two additional factors, however, severely limit discretionary spending cuts at this time. The first is the safety performance measures mentioned above. These standards can require the Company to prioritize capital projects based not necessarily on safety or organic growth requirements, but rather to avoid the imposition of penalties.⁹ Were the Commission to waive the application of the safety performance standards, additional savings might be achievable without jeopardizing the provision of safe and adequate service.¹⁰

Another impediment to capital cuts is the federal stimulus program. As the Commission is aware, the federal government's approach to the current economic crisis has been to increase spending in an effort to generate increased employment. In

⁸ A related example is a bill, currently pending before the state legislature, proposing to mandate where a utility locates its call centers. If this law is adopted, management's cost-based objective behind locating call centers will be replaced by the legislature's objective that disregards cost altogether. The result will be higher costs and less discretion by management to do anything about it.

⁹ The Company's dispute with the Commission over the efficacy (and legality) of its safety performance measures is well documented and will not be repeated here. There can be no debate, however, that the safety performance measures limit discretionary spending reductions.

¹⁰ Waiver of the safety performance standards does not mean that the Company would ignore them. Rather it means that the Company would continue to observe the standards and schedule repair and replacements on the basis of need, to the extent achievable, rather than merely to avoid the imposition of penalties.

Distribution's service territory, federal stimulus is funding sizable infrastructure projects, including road construction that in some cases will require Distribution to replace pipeline not otherwise scheduled for replacement, exerting upward pressure on Distribution's capital budget.

The Company recognizes the Commission's obvious frustration with the effect of the assessment and local property tax increases, among other taxes, that are imposed on New York's utilities by the state and its municipal subdivisions. The Commission's concern over customers' increasing difficulty paying bills is apparently not shared by state and local lawmakers, who have taken handily to treating utilities as convenient tools for assessing ever more taxes on an increasingly beleaguered population of utility customers. Despite this unfortunate outcome, the legislative decision to impose new and higher taxes on utility customers arguably renders the resulting increase in utility rates reasonable as a matter of law. It should not then be the Commission's role to attempt to relieve customers of the tax burden imposed through the political process by cutting spending for utility purposes. And yet, this is what the Notice attempts to do.¹¹

The Company is mindful of the Commission's directive that companies identify programs and expenses that might be reduced or deferred during the duration of the recession. Although reasonable minds may differ on the efficacy of the form of customer relief chosen by the Commission - particularly given the significant relief in the form of lower gas costs and the effort to stimulate the economy by increasing public spending¹² -

¹¹ More than one-half of the increase in rates approved for Consolidated Edison in its recent rate case is attributed to increases in local taxes and the Section 18-a assessment. Case 08-E-0539, Consolidated Edison, supra.

¹² As noted above, Distribution is a major employer and consumer of contractor services in western New York. Austerity measures that reduce the Company's spending for contracted services can unwittingly generate a negative economic impact by contributing to job losses. Consolidated Edison speaks to this matter in its Petition for Rehearing filed in Case 08-E-0539 on May 26, 2009 (at pp. 6, 18-22).

the Company has identified several items that are candidates for customer savings. In developing its proposed savings, the Company was guided by the Commission's instructions to seek cost reductions "without impairing the ability to provide safe and adequate service." Notice at 2.

Customer Savings Proposals

The Notice leaves to utilities' discretion which "capital expenditures, operation and maintenance expenses and any other expenses . . . may be reduced . . ." Notice at 2. Undoubtedly the objective of the Notice is to produce customer savings. As more fully described below, Distribution has identified potential available funds in various forms of up to \$6.2 million that, with the Commission's approval, can be credited to customer bills to produce immediate savings.

Distribution recommends that the savings be passed along to customers through either existing bill credit mechanisms or a "one-time" bill credit, also explained below.

Assumptions Behind Proposed Savings

Two important assumptions underlie the Company's customer savings proposed below. The Company assumes that the Commission will grant it the authority to recover, without delay, the increase in the Public Service Law §18-a assessment, as proposed in Case 09-M-0311.¹³ Distribution assumes further that the Commission will approve a petition filed by the Company on September 16, 2008 requesting blanket authority to defer expenses relating to investigation and remediation of former manufactured gas plant ("MGP") sites, including in particular a site undergoing clean-up in Tonawanda,

¹³ Case 09-M-0311, Implementation of Chapter 59 of the Laws of 2009 Establishing a Temporary Annual Assessment pursuant to Public Service Law §18-a(6), Notice Requesting Comments (issued April 28, 2009).

New York.¹⁴ The assessment increase, at \$24 million annually, is equal to approximately 17.5% of Distribution’s operating and maintenance expense. The expenses anticipated for the Tonawanda MGP site are estimated to be as high as \$20 million, and other sites have been identified by the state Department of Environmental Conservation. Absent the anticipated rate treatment, the Company cannot responsibly implement the savings identified below and the Company will instead be forced to seek an immediate increase in rates.

Proposed Credits

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|----|--|-------------|
| 1. | <u>State Income Tax Overcollection</u> | \$3,069,254 |
|----|--|-------------|

The Company currently maintains a balance of state income tax (“SIT”) overcollections in the amount of \$3,069,253.53 as of April 30, 2009. This amount is the excess of the SIT refund approved in the 2007 Rate Order. These funds would ordinarily be included in rates (as an offset or credit) approved in a future rate case. They are therefore available for a customer credit today.

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|----|--------------------------------|-------------|
| 2. | <u>Area Development Grants</u> | \$1,000,000 |
|----|--------------------------------|-------------|

The Company’s Area Development Program (“ADP”) was approved by the Commission in Case 04-G-1047, National Fuel Gas Distribution Corporation – Rates, Order Approving Area Development Program (issued June 2, 2006). The ADP was adopted “to provide development grants to community based organizations or local development authorities for specific economic development projects in order to expand economic development opportunities in NFGD’s service territory.” By its terms, the

¹⁴ Case 08-G-1315, Petition of National Fuel Gas Distribution Corporation for Authorization to Defer the Costs Related to the Environmental Clean-Up of the Manufactured Gas Site located at 126 East Niagara Street in Tonawanda, New York (September 16, 2008). The Petition asks the Commission to confirm that the Company has blanket authority to defer site investigation and remediation (“SIR”) expenses or in the alternative to grant such authority.

Distribution also believes that the outreach and education program for the current CIP year ending November 30, 2009 can be reduced by \$800,000 without diminishing the quality of the messaging required to maintain adequate levels of customer awareness.

Reductions in CIP spending are automatically credited to customers by operation of the CIP surcharge reconciliation mechanism. Should the Commission prefer that the savings be passed along through a different mechanism, the Company will retain the surplus pending further instructions.

4. Other Costs \$350,000

As explained above, Distribution engages in aggressive cost-control measures as a matter of course. In response to the contraction in financial markets, Distribution and its affiliates undertook additional, short-term cost-saving measures, like other companies, in order to preserve cash and avoid the capital markets. These measures and any measures taken since then also avoid the need to increase rates. Although the Company has not identified any department-specific savings at this time, it has, since September 2008, focused its efforts in particular on executive compensation, capital spending, employee activities, information systems costs and other discretionary items. Those efforts will contribute an additional, one-time amount of \$350,000 to the bill credit proposed in this filing.

5. Other Actions

Current NYMEX gas prices are at their lowest since October 2002. Although Distribution's sales customers are receiving the benefit of lower gas costs through the ordinary operation of the gas adjustment clause, Distribution believes that greater savings might be achieved for customers who elect to enroll in a utility-offered fixed price option

("FPO"). In 1997, the Commission directed gas utilities to offer an FPO in response to concerns about volatility then being experienced in gas commodity markets. Case 97-G-0600, Order Requiring the Filing of Proposals to Ameliorate Gas Price Volatility and Requesting Comments (issued June 5, 1997). After the FPO period expired, the Commission discouraged utility FPOs in favor of promoting the sale of FPOs and other products by ESCOs.¹⁵ The Commission has determined, however, that these extraordinary times justify unconventional actions. Distribution therefore proposes to offer a FPO again on a limited basis in order to provide customers with the ability to "lock in" to lower gas costs, if they remain available, for a fixed period of time. The FPO could be designed generally in accordance with the requirements contained in the Commission's 1997 order. The Company recognizes and agrees that the purpose of a FPO is to ameliorate volatility and not necessarily to produce savings. However, an FPO is nonetheless a proven sales item that should be made available as another means of enabling customers to gain greater control over household costs.

Implementation

The Company proposes to voluntarily credit customers with the savings identified above through two mechanisms. Savings achieved in the CIP (\$1.8 million) will be automatically credited to customers through the CIP surcharge reconciliation. Customers would realize the effect of those savings under current tariff provisions through a reduction to CIP surcharge beginning March 1, 2010. For the remaining amounts (\$4.4 million), Distribution would utilize existing mechanisms to credit customers on a monthly basis over an annual period beginning no less than thirty days after the Commission approves the Company's proposal.

¹⁵ See, Case 97-G-0600, Order Allowing the Offering of Fixed Price Options (issued June 5, 1998).

The Company would also offer the possibility of a “one-time” bill credit for the winter period. Under this proposal the Company would allocate \$5.2 million among all customers on their January 2010 bill.¹⁶ The remaining savings, in the amount of \$1,000,000, would be credited to customer bills through the existing CIP rate mechanism.

Conclusion

The Company’s proposals are designed to generate bill credits that, if approved, would provide meaningful relief to customers. Standing alone, the above austerity and other measures fully comply with the Commission’s intent behind the Notice. Factoring in projected lower gas costs¹⁷ and a delivery charge that has held steady since 2007, customers will experience savings over last year’s bills, even including the increase attributable to the higher utility assessment.

The Company emphasizes that its proposed austerity savings cannot responsibly be provided if the Commission denies or postpones relief previously requested by Distribution for the increase in the utility assessment and anticipated SIR costs. Assuming such relief is granted, however, the Company is prepared to implement the above savings on short notice, or as otherwise directed by the Commission.

Respectfully submitted,



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¹⁶ Total of \$6.2 million less the CIP Year 3 (year ending November 30, 2010) savings of \$1 million.

¹⁷ Distribution recognizes that gas prices are highly volatile and could increase.