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BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Long-Term Forecast Report of Vectren Energy Delivery of Ohio, Inc. and Related Matters.	)))	Case No. 05-120-GA-FOR
In the Matter of the Regulation of the Purchased Gas Adjustment Clause Contained Within the Rate Schedules of Vectren Energy Delivery of Ohio, Inc. and Related Matters.	))))	Case No. 04-220-GA-GCR Case No. 05-220-GA-GCR

REPLY BRIEF

Samuel C. Randazzo (Trial Attorney)
Gretchen J. Hummel
Lisa McAlister
Daniel Neilsen
McNees Wallace & Nurick LLC
21 East State Street, 17th Floor
Columbus, OH 43215-4228
Telephone: 614-469-8000
Telecopier: 614-469-4653
sam@mwncmh.com
ghummel@mwncmh.com
lmcalister@mwncmh.com
dneilsen@mwncmh.com

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Attorneys for Vectren Energy Delivery of Ohio, Inc.

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REPLY BRIEF

I. BACKGROUND

On December 15, 2006, Vectren Energy Delivery of Ohio, Inc. ("VEDO") and the Commission Staff ("Staff") filed a Stipulation and Recommendation ("Stipulation") resolving all but one of the issues presented in these proceedings. The unresolved issue is the disposition of the recommendation made by the Management/Performance ("M/P") auditor, Utilities International, Inc. ("UII" or "M/P Auditor") in its Audit filed on August 16, 2006, that "VEDO should refund $831,740 to GCR customers for its 5% reserve margin for November 1, 2002 through October 1, 2003." M/P Audit at 74, Recommendation 1. The Stipulation provided that, "... this recommendation should be submitted to the Commission for its consideration and resolution." Additionally, the Stipulation provided that, "... VEDO's testimony, the Management/Performance Audit Report filed by Utilities International, Inc. on August 16, 2006, the two Financial Audits filed by Deloitte and Touche LLP on July 15, 2005 and August 18, 2006, and the two

Uncollectible Expense Rider Audit Reports filed by Deloitte and Touche LLP on August 31, 2005 and August 18, 2006 should be admitted as evidence in these proceedings and that said evidence supports the reasonableness of this Stipulation and Recommendation, taken as a whole, consistent with the criteria that the Commission has adopted for purposes of evaluation of settlements."

On December 29, 2006, the Attorney Examiner issued an Entry requiring that briefs regarding the unresolved issue be filed by January 3, 2007, and reply briefs by January 12, 2007. On January 3, 2007, The Office of the Ohio Consumers' Counsel ("OCC") filed its brief as required ("OCC Brief"). This Reply Brief is VEDO's response thereto.

II. RELEVANT STANDARD OF REVIEW

The statutory prescription which requires utility recovery of gas costs pursuant to the purchased gas adjustment clause and limits the Commission's discretion related thereto is found in Section 4905.302, Revised Code, which provides, in pertinent part:

> (A)(1) For the purposes of this section, the term 'purchased gas adjustment clause' means:
>
> (a) A provision in a schedule of a gas company or natural gas company that requires or allows the company to, without adherence to section 4909.18 or 4909.19 of the Revised Code, adjust the rates that it charges to customers in accordance with any fluctuation in the cost to the company of obtaining the gas that it sells, that has occurred since the time any order has been issued by the public utilities commission establishing rates for the company pertaining to those customers....
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> * * *
>
> (E) The commission shall not at any time prevent or restrain such costs as are distributable under this section from being so distributed, unless the commission has reason to believe that an arithmetic or accounting inaccuracy exists with respect to such a distribution or that the company has not accurately represented the amount of the cost of a special purchase, or has followed imprudent or unreasonable

> procurement policies and practices, has made errors in the estimation of cubic feet sold, or has employed such other practices, policies, or factors as the commission considers inappropriate.

Section 4909.302, Revised Code. It is clear that natural gas companies are entitled by law to recover all actual gas costs unless there exists sufficient evidence to support a Commission finding of arithmetic error, imprudence, or unreasonableness in the company's gas procurement practices and policies. In other words, Section 4905.302(E), Revised Code, identifies the limited circumstances that permit the Commission to deprive a natural gas company, such as VEDO, of the ability to recover the actual costs incurred to make a reliable gas supply available to its sales customers.

In 1986, the Commission explicitly adopted guidelines promulgated the year before by the National Regulatory Research Institute ("NRRI") for the assessment of utility decisions as follows:

> The Commission believes that assessments of the prudence of a utility's decisions should be made in accordance with the four guidelines suggested by the National Regulatory Research Institute (NRRI). These guidelines were reported in *The Prudent Investment Test in the 1980s*, NRRI-85-16, April, 1985, and are summarized, very briefly as follows:
>
> 1. There should exist a presumption that decisions of utilities are prudent.
> 2. The standard of reasonableness under the circumstances should be used.
> 3. Hindsight should not be used in determining prudence, although consideration of the outcome may legitimately be used to overcome the presumption of prudence.
> 4. Prudence should be determined in a retrospective, factual inquiry.

See *In the Matter of the Regulation of the Purchased Gas Adjustment Clause Contained within the Rate Schedules of Syracuse Home Utilities Company, Inc. and Related Matters*, Case No. 86-0012-GA-GCR, Opinion and Order at 10 (December 30, 1986) [hereinafter referred to as *Syracuse*].

These standards have not been met in these cases. There is no record evidence for the *audit period in these proceedings* which supports the disallowance recommended by the M/P Audit Report and parroted by OCC. It must be remembered that the Commission cannot disallow recovery of gas procurement costs unless it explicitly finds arithmetic errors or imprudent or unreasonable procurement practices. Section 4905.302, Revised Code. Here, in the winter of 2002/2003 VEDO paid for and received 34,000 DTH of pipeline transportation service via contracts with Columbia Gas and Texas Gas. M/P Audit at 30-31. Thus, it must be shown that obtaining such services to assure reliable service in the peak season constituted an imprudent practice in this audit period.

Of particular importance is the Commission's recognition of the significance of the presumption of prudence and the requirements borne by a party seeking to overcome that presumption. In *Syracuse*, the Commission addressed this relationship as follows:

> The first [NRRI] guideline is important in this case because the effect of a presumption of prudency is to shift the 'burden of producing evidence' (or 'burden of production') to the opposing party. While the 'burden of persuasion' (or 'burden of proof') generally rests throughout a proceeding on the same party, the burden of producing evidence can shift back and forth. Here, pursuant to Rule 4901:1-14-08, Ohio Administrative Code, Syracuse always has the burden of proving that its gas cost recovery rates were fair, just, and reasonable and that its gas purchasing practices and policies promote minimum prices consistent with an adequate supply of gas. The effect of presuming that Syracuse's decisions ... were prudent shifts to the Staff the burden of producing evidence to rebut that presumption. The Staff has simply produced no evidence sufficient to overcome the presumption. The Staff's evidence consists primarily of conclusory statements or unsubstantiated references.

Syracuse at 10. Finding that the Staff's positions lacked evidentiary support, the Commission observed that "... Syracuse's evidence, while admittedly also not empirically conclusive, supports the basic facts underlying the presumption." Consequently, the Commission found that "... [t]he Staff must do more than essentially state 'we disagree' to shift the burden of producing additional evidence back to the Company." *Id.* at 11.

The presumption in favor of utility judgment is not peculiar to Ohio. It is the law of the land. The United States Supreme Court has cautioned utility regulators about second-guessing utility management. In addressing a decision of the Public Service Commission of Missouri establishing rates for Southwestern Bell Telephone Company, the Court said of the Commission dismissal of company evidence in favor of its own judgment:

> There is nothing to indicate [utility management] bad faith. So far as appears, plaintiff in error's board of directors has exercised a proper discretion about this matter requiring business judgment. It must never be forgotten that while the State may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies and is not clothed with the general power of management incident to ownership. The applicable general rule is well expressed in *State Public Utilities Commission ex rel. Springfield v. Springfield Gas and Electric Company*, 291 Ill. 209, 234.
>
> The Commission is not the financial manager of the corporation and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses unless there is an abuse of discretion in that regard by corporate officers.
>
> See *Interstate Commerce Commission* v. *Chicago Great Western Ry. Co.*, 201 U.S. 108; *Chicago, Milwaukee & St. Paul R.R. Co.* v. *Wisconsin*, 238 U.S. 491; *People ex rel.* v. *Stevens*, 197 N.Y. 1, (emphasis added).

See *S.W. Tel. Co. v. Pub. Serv. Comm.*, 262 U.S. 276, 288-289 (1923).

Several years later, the United States Supreme Court stated that, when evaluating utility business decisions:

> Good faith is to be presumed on the part of managers of a business. *Southwestern Bell Telephone Co.* v. *Public Service Commission of Missouri*, 262 U.S. 276, 288, 289. In the absence of a showing of inefficiency or improvidence, a court will not substitute its judgment for theirs as to the measure of a prudent outlay. *Banton* v. *Belt Line RY. Corp.*, 268 U.S. 413, 421; *Brooklyn Borough Gas Co.* v. *Prendergast*, 10 F.2d 167, 181.

See *West Ohio Gas Co.* v. *Comm'n.* (No. 1), 294 U.S. 63, 72 (1935).

The Ohio Commission's historical decisions demonstrate that it believes that the evaluation of prudence and reasonableness should not be treated casually, and it has appropriately treated the required presumption in favor of the reasonableness and prudence of utility decisions with great deference. The *Syracuse* proceeding cited above addressed the issue of the reasonableness of the transportation rate for which Syracuse contracted to transport gas from Columbia Gas Transmission Corp. to its system through a pipeline (less than one mile in length) to its distribution system. *Supra,* at 8. In spite of record evidence that the transportation rate had been increased three times pursuant to changes of ownership prior to expiration of any of the relevant contracts and that the ultimate owner of the pipeline shared office space with the previous pipeline owner who was also the father of the owner of Syracuse, the Commission refused to find imprudence as recommended by its Staff. *Id.* at 7-9. As referenced above, the Commission, referring to the NRRI guidelines it adopted, responded to its Staff's arguments as follows:

> .... Syracuse has always had the burden of proving that its gas cost recovery rates were fair, just, and reasonable and that its gas purchasing practices and policies promote minimum prices consistent with an adequate supply of gas. The effect of presuming that Syracuse's decisions to renegotiate its transportation rates were prudent shifts to the Staff the burden of producing evidence to rebut that presumption. The Staff has simply produced no evidence sufficient to overcome the presumption. The Staff's evidence consists primarily of conclusory

> statements or unsubstantiated inferences. The Staff states that the $.30 MCF is too high, but has conducted no cost of service study to demonstrate why. The Staff denounces the fact that Herlman Gibson [President of Syracuse] and Edward Pinney [President of E & L Enterprises, which purchased the pipeline from the father of Herlman Gibson] share office space, but fails to produce any evidence that the parties failed to negotiate at arms-length in good faith. The Staff criticizes Syracuse for considering the cost to E & L of repairing the pipeline since there was no empirical evidence to show the cost was great, yet offers no evidence to show that the cost was minimal. Moreover, Syracuse's evidence, while admittedly also not empirically conclusive, supports the basic facts underlying the presumption. Syracuse demonstrated that it considered the costs to E & L of purchasing and maintaining the pipeline itself, the fact that the Syracuse system cannot be served gas without the pipeline, and the possibility of completing negotiations for less expensive gas, in determining whether it were prudent to renegotiate the transportation costs. The Staff must do more than essentially state 'we disagree' to shift the burden of producing additional evidence back to the Company.

Supra, at 10-11.

In these cases, the M/P Auditor recommended the disallowance at issue absent any consideration of or reference to the underlying facts or circumstances of the relevant audit period and cannot, therefore, meet the requirement of producing sufficient evidence to rebut the presumption that VEDO's audit period gas procurement policies and practices are prudent and reasonable, resulting in reasonable and just gas costs to customers. To the contrary, as discussed below, VEDO's direct evidence and the M/P Audit Report findings related to VEDO's audit period performance confirm the presumption of reasonableness guaranteed by the application of the Commission's standard of review.

III. HISTORICAL PERSPECTIVE

The M/P Auditor recommended an $831,740 disallowance for VEDO's 5% reserve margin solely, "[s]ince the PUCO concluded in the previous audit that a 5% reserve margin in combination with already conservative design day criteria was imprudent...." M/P Audit at 30.

The Commission conclusion in the last case ("2002 GCR Case") was based on a *de novo* review of the contents of historical long-term forecasts previously reviewed and approved in proceedings, the records of which were closed before the initiation of the M/P Audit in that case. *See In the Matter of the Regulation of the Purchased Gas Adjustment Clause Contained Within the Rate Schedules of Vectren Energy Delivery of Ohio, Inc. and Related Matters,* Case No. 02-220-GA-AIR, Opinion and Order at 5, 24-36 (June 14, 2005) ("2002 GCR Order"). In its 2002 GCR Order, the Commission decided to disallow the costs associated with the 5% reserve margin on the basis that the 5% reserve margin, in combination with the previously-approved forecast design day criteria, was inappropriate and caused excess capacity on VEDO's system. *Id.* at 31-32.

In its review of VEDO's performance in its 2002 GCR Order, the Commission declined to recognize the economic benefits of the capacity reduction rights contained in the supply portfolio management agreement VEDO negotiated to mitigate stranded capacity costs of VEDO's choice program because no actual dollar benefit was achieved in the audit period in the last case. *Id.* at 19. Likewise, the Commission ignored the access to capacity for third party suppliers at no risk to customers accomplished by VEDO. *Id.* The Commission rejected uncontroverted evidence of the actual value of

VEDO's capacity in evaluating VEDO's portfolio management agreement. *Id.* at 17-20, 2002 GCR Entry on Rehearing at 6-9 (August 10, 2005).

These matters, which are implicated in the appeal VEDO initiated at the Ohio Supreme Court from the 2002 GCR Order,[1] are not replicated in the facts and circumstances of the audit period and reviewed by the M/P Auditor in these proceedings. As addressed above and below, the facts and circumstances of the audit period in these proceedings do not support a disallowance.

IV. DISCUSSION

At the outset of its Audit Report, UII described the GCR audit process and VEDO's gas supply performance as follows:

> Findings of imprudence resulting in cost disallowances, as those from the previous audit, represent a failure of both the Company and the regulatory process to properly serve GCR customers. Fortunately, for both the Commission and the Company, this is clearly no longer the case. Most of the adverse findings in this report represent areas for improvement rather than deficiencies which should be the way the Ohio management/performance audit process functions. UII subjected VEDO to rigorous gas supply management and procurement standards that we consider best practices in the industry and the Company was acceptably close to meeting them in most areas for which they should be commended. M/P Audit at 29.

With respect to VEDO's performance during the audit period, from a cost perspective, UII specifically found:

1) In 2003/2004, VEDO shed capacity prior to the actual expiration of its pipeline contracts by exercising capacity reduction rights it negotiated in its contract with ProLiance Energy, and saved customers $1.435 million, actually leaving it with a negative capacity reserve margin during part of the audit period (*see* M/P Audit Exhibit III-1 at 31); and

[1] *Vectren Energy Delivery of Ohio, Inc. v. Public Utilities Commission of Ohio*, Supreme Court Case No. 05-1900.

2) In 2004/2005, VEDO reconfigured its capacity portfolio and reduced its annual demand costs by $8 million (Pergola at 6, M/P Audit at 32)—VEDO created a significant portion of these savings by dropping Columbia Gas FT (firm capacity) and relying on secondary firm capacity to refill its storage, a calculated risk by VEDO management that has saved customers significant costs on an ongoing basis. M/P Audit at 33.

The M/P Audit Report also found that VEDO, through receipt of favorable compensation from ProLiance for its available capacity when compared to market values (M/P Audit at 48,49), and through its commodity hedging program which saved customers $25 million, performed very well for customers from a cost perspective during the audit period. However, the two findings highlighted above relate directly to the capacity reserve margin issue in this audit period and must, together with VEDO's overall commendable performance, be considered in evaluating the recommended disallowance.

VEDO exercised its capacity reduction rights as it implemented its choice program on January 1, 2003. At that time, the magnitude of customer load migration, the potential for customers to return to GCR sales service if dissatisfied with choice supplies, and the potential of supplier defaults were unknowns that VEDO faced. The decision to shed capacity in 2003 to reduce costs by $1.4 million, while continuing to maintain a small reserve margin as a company policy, represented a reasonable decision. As shown above, due to the capacity reduction, in a later non-peak period VEDO aggressively took the position of having a negative reserve in order to reduce its costs. Company Ex. 2 at 5-6.

Later in the audit period, VEDO decided to save further costs for its customers by relying on secondary firm capacity for storage refill, something its predecessor had not done, and a creative approach no GCR audit ever recommended. This risk, in terms of the use of non-firm capacity which is not the typical LDC approach, netted significant cost savings on an on-going basis for customers. M/P Audit at 32-33.

These capacity decisions can each be evaluated in isolation, or can be viewed holistically in terms of whether VEDO management has managed its capacity to reliably and cost-effectively serve its customers' interests. Certainly, the latter approach comports with the purpose of the GCR audit process. To penalize one decision related to the level of acceptable winter season risk as a choice program was implemented, while taking the far larger benefits from the innovative use of secondary capacity that allowed VEDO to drop expensive firm capacity, and the unique ability to shed firm capacity prior to its contractual expiration is unfair and represents a piecemeal review of the gas supply process that fails to consider overall performance, and provides no recognition of good efforts to reduce costs.

Even a crude approach of netting the audit period benefits of VEDO's ability to shed capacity by using its negotiated capacity reduction rights ($1.4 million) or by using secondary capacity (part of the $8 million demand cost reduction) against the $831,000 reserve margin issue results in no capacity cost disallowance in this audit period.

Ignoring these real cost benefits that VEDO created for its customers, the fact is that there is no basis in the record in this proceeding to disallow the reserve margin costs. OCC erroneously states that VEDO is trying to "over-ride" a prior PUCO decision. OCC Brief at 4. That is not the case. The PUCO never found that reserve margins are inappropriate. Rather, in the prior audit the PUCO acknowledged that many utilities use reserve margins and they can be reasonable. 2002 GCR Order at

36. The prior disallowance stemmed from the PUCO's review of the results of the 2001 design day LTFR which it considered to be too conservative (2002 GCR Order at 31), and this conclusion, when combined with a 5% reserve margin, led to a finding of excess capacity costs. Of course, in that prior audit, the choice program, and its attendant risks were not yet at issue since choice had not been implemented, nor were there offsetting capacity cost savings to consider since they did not begin to occur until 2003.

Moreover, UII's review of the 2003 LTFR that actually pertains to the winter in question does not support a finding of an overly conservative design day. From the outset, UII disagreed with elements of Liberty's audit report,[2] including Liberty's erroneous suggestion that VEDO failed to use proper NOAA data. M/P Audit at 37. While UII believed that the use of prior day temperature as part of the peak day model tended to make VEDO's design more conservative, UII did not reach such a statistical conclusion, and expressly stated that its review "should not be taken as a legitimate basis for cost disallowance." M/P Audit at 41. UII further found that VEDO's model had a bias that likely under-forecast peak day sendout which would offset the potential for an overly conservative peak day design. *Id.* These findings, which call into question certain Liberty conclusions, result in no basis for a conclusion that in this audit period the design day was too conservative. Thus, the evaluation of the 2001 LTFR for a prior period cannot be automatically used as the sole basis for a disallowance of actual costs in a subsequent period.

[2] The M/P Audit in Case No. 02-220-GA-GCR was conducted by Liberty Consulting Group.

OCC's brief can be distilled into two points: The Commission's decision in the last case should be blindly applied to this audit period, regardless of the record in this case; and VEDO's excellent performance in this audit period, both from an overall perspective as well as related directly to its ability to reduce the cost of pipeline capacity, is irrelevant. Neither point has merit. OCC treats the recommended disallowance as something the Commission can do as a matter of law, that is, a finding it can make based on its determination of excess capacity[3] it made in the last case. OCC Brief at 3. As VEDO has previously explained and as is discussed herein, the implicit finding of imprudence recommended by OCC must rest on an affirmative demonstration that VEDO has done something wrong.

The evidence in this case clearly demonstrates that the facts and circumstances of the audit period reviewed here are different from those considered in the last case, consistent with the discussion of the M/P Audit Report findings and VEDO's direct case discussed above. Consequently, the Commission's decision in the last case, since it cannot account for these differences, cannot be dispositive of the issues in this case. Moreover, VEDO's audit period performance has everything to do with the evaluation required of the Commission. OCC has offered no evidence to rebut the M/P Auditor's conclusion that, for its audit period performance, VEDO "should be commended," and has no counter to the fact that the $831,000 cost for a winter reserve margin is dwarfed by other proactive actions taken by VEDO to reduce capacity costs by millions of dollars during this audit period.

[3] No disallowance for excess capacity can be made absent the cost benefit analysis to determine the net effect of the excess capacity required by Commission precedent. See *In Re Application of Dayton Power and Light Company,* Case No. 76-823-EL-AIR, Finding and Order at 6-7 (July 22, 1977).

V. CONCLUSION

In sum, the record in this proceeding clearly discloses that both the M/P Auditor and OCC relied solely on the Commission's decision in VEDO's last GCR proceeding to support the recommended disallowance of $831,740 related to the reserve margin in the first winter season of this audit period. The evidence in the record in these proceedings, however, compels a different result. VEDO's realization of more than $35 million in cost savings for GCR customers and its achievement of overall GCR costs and residential customer bills consistent with or better than the other three large Ohio gas companies necessitates a finding that VEDO's gas procurement practices and policies during the audit period were prudent and reasonable. There is no evidence in the record in these proceedings to support the disallowance recommended by the M/P Auditor and OCC. Inherent in the GCR process is the fact that when VEDO achieves unique costs savings such as the ability to shed $1.4 million of capacity costs through negotiating unilateral capacity reduction rights, it does not keep any of the savings. When VEDO opportunistically sheds firm capacity and takes on some risk by using secondary capacity to reduce costs, it does not earn some form of compensation. If these actions benefit customers and are accepted and approved, then a single decision to incur $831,000 of real cost to have a winter season reserve in place at the same time a choice program (and the potential of supplier defaults) commences should not be singled out and punished. A fair regulatory process that properly serves customers and considers the record evidence dictates that no disallowance be ordered in this audit period.

Respectfully submitted,

Samuel C. Randazzo (Trial Attorney)
Gretchen J. Hummel
Lisa McAlister
Daniel Neilsen
McNees Wallace & Nurick LLC
21 East State Street, 17th Floor
Columbus, OH 43215-4228

Attorneys for Vectren Energy Delivery of Ohio, Inc.

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing *Reply Brief* was served upon the following parties of record this 12th day of January 2007, *via* electronic transmission, hand-delivery or ordinary U.S. mail, postage prepaid.

Gretchen J. Hummel

PARTIES OF RECORD

Bobby Singh
Chester, Willcox & Saxbe LLC
65 E. State Street
Suite 1000
Columbus, OH 43215

Joe Serio
Assistant Consumers' Counsel
Office of the Ohio Consumers' Counsel
10 W. Broad Street, 18th Floor
Columbus, OH 43215

Thomas Lindgren
Assistant Attorney General
Public Utilities Commission of Ohio
180 E Broad Street, 9th Floor
Columbus, OH 43215