BEFORE
THE PUBLIC UTILITIES COMMISSION OF OHIO

In the Matter of the Regulation of the Purchased Gas Adjustment Clauses Contained within the Rate Schedules of Northeast Ohio Natural Gas Corporation and Orwell Natural Gas Company.	:	Case No. 12-0209-GA-GCR Case No. 12-0212-GA-GCR
In the Matter of the Regulations of the Purchased Gas Adjustment Clauses contained within the Rate Schedules of Northeast Ohio Natural Gas Corporation and related matters.	:	Case No. 12-0309-GA-UEX
In the Matter of the Uncollectible Expense Rider of Orwell Natural Gas Company.	:	Case No. 12-0312-GA-UEX

REPLY BRIEF
SUBMITTED ON THE BEHALF OF THE STAFF OF THE PUBLIC UTILITIES COMMISSION OF OHIO

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INTRODUCTION

During both this and the previous GCR proceeding, Staff and OCC demonstrated that Northeast Ohio Natural Gas Corporation and Orwell Natural Gas Company ("Companies") paid unreasonable local production prices, in large measure because of the inappropriate affiliate transactions. Even though the Commission found this behavior unacceptable in the previous case, a review of the Companies' actions reveals that these problems have continued almost unabated. The Companies have the burden of persuasion in this proceeding. They have failed to meet that burden in this case.

The Staff's investigation in this case was sensible, and consistent with this Commission's directives. The Commission directed Staff to closely monitor the Companies' actions, and to review their compliance with the 2010 Stipulation, including the RFP process, in this audit proceeding. That this is precisely what it did. As Staff noted in its Initial Brief, the plain fact is that the steps taken by these Companies to address issues of self-dealing raised over the course of numerous audits have been woefully inadequate to address concerns raised both by Staff and by this Commission.

The time has come for more incisive investigation, and more decisive action.

ARGUMENT

I. Staff and OCC presented more than enough evidence to rebut any presumption of prudence.

In their initial brief, the Companies discuss the "presumption of prudence" regarding the Companies' decisions.[1] While it is true this presumption initially shifts the burden of production to Staff and OCC, the Companies always have the burden of persuasion in this proceeding. As the Commission articulated in *Syracuse*:

> [The utility] always has the burden of proving that its gas cost recovery rates were fair, just, and reasonable and that its gas purchasing practices *promote minimum prices* consistent with an adequate supply of gas.[2]

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1 Northeast Ohio Natural Gas Corporation and Orwell Natural Gas Company's Post-Hearing Brief (Companies Initial Brief) at 8-12.

2 *In re Syracuse Home Utils. Co*., Case No. 86-12-GA-GCR (Opinion and Order) (Dec. 30, 1986) at 10 (emphasis added).

The only burden placed on Staff and OCC in this proceeding was the burden of producing evidence that the Companies' gas purchasing practices were imprudent. Staff and OCC met this burden by presenting a substantial amount of evidence regarding the unreasonable local production prices paid by the Companies' and the inappropriate affiliate transactions that caused these inflated prices. This evidence was discussed extensively in Staff's and OCC's initial briefs and showed that the excessive amounts the Companies paid for local production were paid solely to benefit the Companies' unregulated affiliate, JDOG Marketing. [3]

This is not the first time the Commission has seen these Companies favoring their affiliates to the detriment of their customers. The Commission admonished the Companies for similar inappropriate transactions in their 2010 GCR cases:

> To date, the companies have benefited from undesirable market conduct and the *Commission finds that behavior unacceptable*…. The Commission is concerned about the companies' *failure to provide the appropriate consumer protections for the regulated ratepayers*, as evidenced through Staff's GCR audit findings and the testimony presented at the hearing. [4]

Unfortunately, the Companies' behavior has not changed. The inappropriate affiliate relationship with JDOG Marketing continued into the 2012 audit and led to unreasonably high local production costs. The record in this case, like the record in the 2010 case,

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[3] Staff Initial Brief, at 2-10. OCC Initial Brief 10-19.

[4] *In the Matter of the Regulation of the Purchased Gas Adjustment Clauses Contained Within the Rate Schedules of Northeast Ohio Natural Gas Corporation and Orwell Natural Gas Company*, Case Nos. 10-209-GA-GCR *et al*. (Opinion and Order) (October 26, 2011) ("2010 O&O") at 24-25 (emphasis added).

highlights these continuing problems. This evidence is enough to overcome any presumption that the Companies' local production purchasing practices were reasonable.

II. The Companies failed to produce any credible evidence explaining why they paid unreasonably high prices for local production.

After Staff and OCC presented evidence of the Companies' imprudent gas purchasing practices, the Companies were obligated to rebut this evidence and prove their gas purchasing practices were reasonable. During the hearing, the Companies relied almost entirely upon a single witness, Dr. Overcast, to prove that their local production purchasing practices were reasonable and the prices the Companies paid for local production were justified.[5] This reliance upon Dr. Overcast continues in the Companies' initial brief.[6]

The integrity of Dr. Overcast's analysis depends on the accuracy of Dr. Overcast's Schedule 1.[7] Staff witness Sarver's testimony shows that Dr. Overcast's Schedule 1 is filled with errors.[8] Because the Companies *never* challenged Mr. Sarver's testimony on this subject, it is safe to assume the Companies acknowledge these errors. When accounting for these inaccuracies, Schedule 1 proves Staff's point: the Companies paid

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5 Companies Ex. 5 (Direct Testimony of H. Edwin Overcast) (Overcast) at 11-14. Although a number of other witnesses for the Companies testified at the hearing, only Dr. Overcast specifically addressed the alleged reasonableness of the prices paid for local production.

6 Companies Initial Brief at 16 -21.

7 Companies Ex. 5 (Overcast), Schedule 1.

8 Staff Ex. 2 (Sarver) at 23-24. Staff Initial Brief at 13.

more for local production than interstate gas, which made no economic sense.[9] The substantial errors in Dr. Overcast's Schedule 1debunks his theory regarding the reasonability of the Companies' local production purchasing practices.

There are other serious flaws in Dr. Overcast's testimony, which the Companies simply reiterate in their initial brief. Dr. Overcast claims that the intrastate gas contracts between JDOG Marketing and the Companies are "full requirements" contracts.[10] Dr. Overcast is wrong. The local production agreements that the Companies had with JDOG Marketing were best efforts agreements, not full requirements contracts.[11] These best efforts agreements are interruptible, which makes these contracts *less* valuable, not more valuable as Dr. Overcast incorrectly claims.[12] There is no record support for Dr. Overcast's and the Companies' assertion that JDOG Marketing was providing "full requirements" services. As such, Dr. Overcast's "full requirements" theory is baseless and does not help explain the inflated premiums the Companies paid JDOG Marketing.

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9 Staff Ex. 2 (Sarver) at 23-24. Staff Initial Brief at 13.

10 Companies Initial Brief at 20. Companies Ex. 5 (Overcast) at 10-11.

11 2010 Hearing, Staff Ex. 9 and 10 (Intrastate Gas Sales Agreements). These intrastate agreements applied to NEO and Orwell. Article 2 of the contract indicates that "Seller (JDOG Marketing) does hereby agree to sell to Buyer (either NEO or Orwell) *on a best efforts basis*"…" Staff Ex. 9 and 10 at pg. 1 (emphasis added). These agreements (referred to as "JOHND2008 – INTRASTATEsales _LDC #1") were in signed on July 1, 2008 and were in effect until February 23, 2011. OCC Ex. 12 (Direct Testimony of Gregory Slone) (Slone), Attachment 1.

12 Under these best efforts agreements, JDOG Marketing would not be required to deliver the requested amounts of gas if certain issues arose that prevented delivery, such as local producers being frozen off in the winter or system pressures preventing the producers from delivering gas. Commission-Ordered Ex. 1 (Staff Report) at 21.

Another shortcoming in Dr. Overcast's testimony is his false claim that Staff's alternative premium would not allow JDOG Marketing to cover its transportation costs on Cobra.[13] The Companies parrot Dr. Overcast's erroneous statement in their initial brief. [14] Staff witness Sarver disproved Dr. Overcast's claim by showing that Staff's recommended premium would allow JDOG Marketing to recover all its costs and a reasonable amount of profit on the Cobra system.[15] The Companies never challenged Mr. Sarver's testimony on this subject during the hearing.

Staff could point to more weaknesses in Dr. Overcast's testimony, but the above should suffice. These are enough to show that Dr. Overcast is not reliable and that his testimony does not further the Companies' case.

III. The Commission should either disallow all fees paid to JDOG Marketing for purchases of local production or adopt Staff's repricing of local production.

a. The Commission is free to disallow all of JDOG Marketing's local production fees because the Companies failed to prove that their local production purchases were reasonable and prudent.

Because the Companies failed to prove their local production costs were reasonable, Staff made an adjustment to such costs. Instead of recommending a complete disallowance of all of JDOG Marketing's fees, Staff attempted to develop more reasonable local production prices, even though it was under no obligation to do so. The

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13 Companies Ex. 5 (Overcast) at 8.

14 Companies Initial Brief at 27.

15 Staff Ex. 2 (Sarver) at 22, Ex. RS-9, RS-10.

Companies chose not to assist Staff in determining the most accurate alternative price by refusing to provide Staff with copies of all the local production contracts relevant to the 2012 audit period.[16] As such, Staff used the best information available to develop a reasonable alternative pricing methodology.

Staff believes its alternative premiums are reasonable and supported by the record. If, however, the Commission decides not to adopt Staff's recommendation, the Commission should disallow all the marketer fees paid to JDOG Marketing related to the purchase of local production.

b. Staff's usage of NYMEX as a pricing point was reasonable.

The Companies question Staff's repricing methodology because Staff used NYMEX as a pricing point. The Companies claim that Staff's analysis was incorrect because "the gas sold to NEO and Orwell [was] not based on…customary NYMEX contract[s]."[17] Staff, however, never claimed the Companies or JDOG Marketing used NYMEX futures contracts to purchase gas. Instead, Staff testified that the contracts between JDOG Marketing and local producers used NYMEX as an initial pricing point.[18]

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16 Tr. 729-732; Commission-Ordered Ex. 1 (Staff Report) at 12. As Staff discussed in its initial brief, the Companies provided these contracts upon request in the 2010 GCR case. Staff's Initial Brief at 14. In this current case, however, the Companies were not willing to provide these contracts to Staff. *Id*.

17 Companies Initial Brief at 20.

18 Staff Ex. 2 (Sarver) at 22. On cross-examination, Mr. Sarver the difference between and NYMEX futures contract and using a NYMEX as a pricing point in developing prices for local production gas:

These local production contracts were in effect during a portion of the 2012 audit period.[19] Therefore, it was entirely reasonable for Staff to use NYMEX as a pricing point when developing alternative premium prices for local production. Further, Staff witness Sarver testified that most Ohio local producers use NYMEX as a pricing point.[20] The Companies failed to introduce any evidence to rebut Mr. Sarver's testimony.

The Companies also claim that Staff "failed to consider basis differential" in its NYMEX based recommendation.[21] This is not true, either. "Basis differential" is typically defined as the difference between the Henry Hub spot price and the corresponding spot price for natural gas in another specified location.[22] The basis differential, which can be positive or negative, was incorporated into the terms of the local production contracts. Staff explained how this basis differential works in the Staff Report:

> NYMEX is a pricing point, an index, that if used strictly for what Mr. Overcast said it was, it would be a futures contract. But I know very few entities that use that to price their gas. A futures contract is to hedge their price so that they have a defined point at a point in time, but most local producers in the State of Ohio use NYMEX because it's readily available to them. Tr. 790.

19 Tr. 734-735.

20 Tr. 790.

21 Companies Initial Brief at 22.

22 See definition of "basis differential" at http://mlpprotocol.com/mlp-general-info/. A more general definition is "the difference in the value of an underlying commodity between different physical locations and/or different points in time." See http://www.spragueenergy.com/pages/content.aspx?p=Natural%20Gas%20Marketwatch%20Glossary.

> In Staff'ss examination of all producer contracts and pricing sheets provided in the course of the 2010 cases, it appears that nearly all of the pricing was based on NYMEX. *The NYMEX prices were increased (adder), decreased (deduct) or flat (zero adder) depending on the producer's location.*[23]

Basis differentials were part of the prices JDOG Marketing paid to local producers. As Mr. Sarver explained, Staff analyzed the prices JDOG Marketing paid local producers (which included the basis differentials) when determining reasonable alternative premium payments.[24] This disproves the Companies' claims that Staff "failed to consider basis differential" in its analysis.

c. Staff's alternative premiums are reasonable and supported by the record.

In their initial brief, the Companies question the rationale behind Staff's alternative premiums.[25] The Companies claim that Staff's alternative premium amount is "simply a guess."[26] The record proves otherwise. During the hearing, Staff discussed the factors that it considered when developing its alternative premium amounts.

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23 Commission-Ordered Ex. 1 (Staff Report) at 14 (emphasis added).

24 Tr. 725-726. Commission-Ordered Ex. 1 (Staff Report) at 14-15.

25 Companies Initial Brief at 21-28.

26 *Id*. at 24. Although the Companies characterize Mr. Sarver's alternative premiums as guesswork, the record shows that Mr. Sarver is qualified to give an expert opinion regarding what constitutes reasonable local production prices and reasonable natural gas marketer fees. As an employee of the Commission, Mr. Saver has worked on GCR audits for over twenty years. Staff Ex. 2 (Sarver) at 1-2; Tr. 821. He has conducted hundreds of GCR audits over the years. Tr. 821. Moreover, the Companies never challenged Mr. Sarver's expertise during the hearing.

Staff began its analysis by determining the costs that JDOG Marketing incurred to purchase and transport local production, including shrinkage.[27] Staff witness Sarver detailed how he determined these costs in his testimony.[28] After determining JDOG Marketing's actual costs of purchasing and transporting local production for the Companies, Staff determined a reasonable premium amount based upon (1) the level of services JDOG Marketing provided to the Companies and (2) what other marketers charged for providing comparable services. For NEO's system, Staff considered that JDOG Marketing allegedly provides some services, such as contracting with producers, performing daily nominations, and balancing delivery meters.[29] For Orwell's system, Staff considered that almost all local production is delivered directly into Orwell's system and, thus, there is very little JDOG Marketing needed to do to deliver local production into Orwell's system.[30]

After considering the alleged services JDOG Marketing provided on each system, Staff compared the premiums paid to JDOG Marketing with the premiums other marketers supplying gas on the Companies' systems were paid. Staff examined the "third party marketer premiums" of various marketers, such as Constellation Energy, Shell, BP

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27 Staff Ex. 2 (Sarver) at 19-20.

28 Staff Ex. 2 (Sarver), Exs. RS-7, RS-8.

29 2010 Hearing, (Direct Testimony of Marty K. Whelan) at 10-11. 2010 Hearing, (Rebuttal Testimony of Marty K. Whelan at) at 3-4.

30 2010 Hearing, (Direct Testimony of Michael S. Zappitello) at 3.

and Sequent Energy.[31] Staff used the premium amounts charged by these marketers when developing its alternative premium prices. This analysis allowed Staff to determine reasonable prices that would both compensate JDOG Marketing for its costs and provide a reasonable premium.[32] Staff witness Sarver explained why he believed this was a reasonable alterative price in his testimony.[33] The only evidence the Companies presented to counter Mr. Sarver's alternative premiums was Dr. Overcast's testimony. However, as already discussed, Dr. Overcast's testimony is completely unreliable. As such, the record supports Staff's repricing methodology.

IV. Staff's review of matters outside of the audit period was reasonable, appropriate, and consistent with the Commission's orders.

The audits of Northeast Ohio Natural Gas (NEO) and Orwell Natural Gas ("Companies") have become drawn out. Even though the 2010 Audit periods ended on February 28, 2010 and June 30, 2010 for NEO and Orwell, respectively, this Commission's Opinion and Order was not issued in that case until October 26, 2011, more than a year into the current audit period. And a final decision was not issued until January 23, 2012, almost a full two years after the end of NEO's 2010 Audit period. In no small measure, this has been because of the Companies' own (in)actions.

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31 Commission-Ordered Ex. 1 (Staff Report) at 12-13.

32 Staff Ex. 2 (Sarver), Exs. RS-7, RS-8.

33 Staff Ex. 2 (Sarver) at 20-21.

The Companies argue that it is "highly unjust and prejudicial" to hold them to a "higher standard"[34] since the "audit period for Northeast had already ended when the October 23, 2011 [*sic*] Commission Order was issued in the prior audit."[35] But the delay in the 2010 case was due, in no small part, to difficulties that Staff experienced in obtaining information from the Companies.[36]

Ongoing difficulties during this audit compelled Staff to request a delay of the audit report filing deadline.[37] Following a change of counsel, the Companies requested, and obtained, a further delay.[38] A request for yet another continuance[39] was denied.[40] These delays, among other reasons,[41] enabled Staff to, and necessitated that it, examine matters outside of the audit period.

Nor should the Companies be heard to complain. During the hearing of the previous GCR case for these Companies, the Companies introduced contracts entered

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34 Staff submits that the same standard, and not any "higher" standard, should be applied. To the extent that the Commission has already found that the Companies benefitted from undesirable and unacceptable market conduct during the 2010 Audit period, the same conclusion must necessarily apply to its conduct during the current audit period. 2010 O&O at 24.

35 Companies Initial Brief at 15.

36 2010 O&O at 9-10.

37 Motion for Extension Submitted on Behalf of the Staff of the Public Utilities Commission of Ohio (Jan. 18, 2013).

38 Expedited Motion for Extension of the Procedural Schedule (Apr. 26, 2013).

39 Expedited Motion for Extension of the Procedural Schedule (Jun. 12, 2013).

40 Entry (Jun. 13, 2013).

41 As Staff witness Sarver explained, and the Companies noted on brief, one of the reasons was to sync the Orwell and NEO audit periods. Companies Initial Brief at 14.

into outside of the audit period in order to demonstrate "remedial steps the company has taken with respect to its contract administration policies and procedures."[42] The bench there allowed that evidence and testimony into the record on grounds that it was relevant to some of the recommendations made by staff."[43] Indeed, even in this case, the Companies never objected to or moved to strike any evidence or testimony offered on the basis that it was outside of the audit period.

Subsequent to the 2010 GCR hearing, the parties entered into a stipulation. The stipulation provided in part that the Companies would issue a request for proposals for management of their interstate transportation and storage capacity assets, and procurement of gas requirements in both the local and interstate markets.[44] The Companies agreed that purchases from the related marketing entity John D. Oil and Gas Marketing would be subject to Staff review in future GCR proceedings, without limitation.

While the Commission approved that stipulation, it directed that the Companies:

> must ensure that the RFP process and selection criteria provide for an arms-length relationship with their affiliated companies, and result in the selection of a successful bidder that is in the best interest of the utility ratepayers. Accordingly, the Commission directs Staff, *in the next audit*

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42 2010 Hearing, Tr. IV at 669. The record in this case highlighted how ineffectual those remediation efforts were. The most glaring example is the affiliated service company's "verification" of inappropriate processing charges from the affiliated pipeline. The fact that Thomas Smith was president of both the hen and the watchdog reinforces Staff's concerns about self-dealing with the fox.

43 *Id*. at 670.

44 2010 Stipulation and Recommendation (Aug. 18, 2011) at 7.

> *of these companies*, to review the RFP and selection processes implemented by Northeast and Orwell as a result of this order to ensure that the companies are responding to our concerns herein appropriately.[45]

The Commission also specifically ordered Staff to review the compliance of Northeast and Orwell with the stipulation and the terms of its Opinion and Order *in this audit proceeding*.[46]

Staff readily concedes that its investigation went beyond the defined audit period, and that its recommendations are based on the totality of its inquiries. To the extent that the Commission determines that any of the financial adjustments recommended by Staff (or OCC) are not appropriate, adjustments should be limited to the audit period as identified in the Commission's January 23, 2012 Entry.

Staff notes, however, that that Entry initiates financial audits "for the GCR rates effective" for the specified periods.[47] But the Commission further directed the Staff to conduct its audit "[t]o identify and review the purchasing policies employed by the company in its procurement of gas supplies"[48] without restricting that review to the audit period.

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45 2010 O&O at 24.

46 *Id*. at 26.

47 Entry (Jan. 23, 2012) at 2.

48 *Id*.

In addition, the Companies fail to recognize Staff's statutory authority to examine all books, contracts, records, documents and papers of any public utility at any time.[49] This authority exists permits general efficiency, allowing Staff to examine issues it has identified as far forward as possible. This more fully apprises the Commission of issues, and potential issues, and problems and allows them to be addressed and resolved without compounding negative effects.

The Staff's expanded investigation in this case is sensible. In the 2010 case, the Commission found that the Companies had benefitted from undesirable market conduct, and that that behavior was unacceptable.[50] As a result, the Commission directed its Staff "to monitor closely the actions of the Companies to ensure that the Companies are in compliance with the rules and regulations, as well as stipulation in this case."[51] Staff respectfully submits that this is precisely what it did in this case.

The Companies urge the Commission to limit its review of the audit period to the timeframe set forth in the January 23, 2011 Entry.[52] Neither statute nor rule so limits the Commission's authority, and the Commission should not be persuaded. Staff agrees that the Commission should only order financial adjustments to rates effective during the prescribed audit period. But the Companies should not be permitted to continue conduct that the Commission has already deemed unacceptable.

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49 Ohio Rev. Code §4903.03.

50 2010 O&O at 24.

51 *Id*. at 25.

52 Companies Initial Brief at 16.

The RFP process highlights the need for this review. The Companies argue that, "[s]imply put, the RFP was not issued in the Audit Period. The results of the RFP have no bearing on the gas cost recovery rate analyzed in the current audit."[53] They seek to evade review on the basis that the RFP was not issued in the audit period, and that it would be inappropriate and premature to examine results that had no impact on rates effective during the 2012 Audit period.

The RFP could have been issued within the biannual audit period commonly adopted by the Commission. Although they claim that the timetable could not be met through "no fault of any party,"[54] it was the Companies alone that delayed in issuing an RFP for nearly 14 months after they had agreed to do so.

But the fact that the contract awarded as a result of the RFP did not impact the rates effective during the audit period does not make it inappropriate to review either the process, or the results of that process, in this case. Indeed, the Commission *specifically directed* the Staff to review the RFP and selection processes *in this audit proceeding* in order to ensure that the Companies were responding appropriately to the Commission's stated concerns.[55]

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53 Companies Initial Brief at 33.

54 *Id*. at 36.

55 2010 O&O at 24.

CONCLUSION

The Companies, of course, bear the burden of proving that their 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.[56] The Companies have failed to meet this burden.

For the foregoing reasons, the Commission should adopt Staff's recommended adjustments. In addition, the Commission should, at a minimum, open an investigation into these companies, and their affiliated regulated pipeline and distribution companies, and order full management and forensic audits.

Respectfully submitted,

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[56] Ohio Adm. Code 4901:1-14-08(B).

PROOF OF SERVICE

I hereby certify that a true copy of the foregoing **Reply Brief**, submitted on behalf of the Staff of the Public Utilities Commission of Ohio, was served by via electronic mail upon the following parties of record, this 30th day of August, 2013.

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Summary: Brief Reply Brief submitted on behalf of the PUCO electronically filed by Mrs. Tonnetta Y Scott on behalf of PUCO