

STATE OF VERMONT
PUBLIC SERVICE BOARD

Docket No. 7109

Petition of Vermont Gas Systems, Inc. for)
approval of an alternative-regulation plan)

Hearing at
Montpelier, Vermont
June 5, 2006

Order entered: 9/21/2006

PRESENT: James Volz, Chairman
David Coen, Board Member
John Burke, Board Member

APPEARANCES: John H. Marshall, Esq.
Downs Rachlin Martin PLLC
for Vermont Gas Systems, Inc.

June E. Tierney, Esq.
for Vermont Department of Public Service

I. INTRODUCTION

In this Order, the Vermont Public Service Board ("Board") approves a Memorandum of Understanding on Alternative Regulation, dated as of July 28, 2006, filed by Vermont Gas Systems, Inc. ("VGS", "Vermont Gas", or the "Company"), and the Vermont Department of Public Service (the "Department"), collectively the "Parties," on July 31, 2006, and in so doing, we hereby approve an alternative regulation plan for the Company.

II. BACKGROUND

On September 1, 2005, VGS filed a petition (Docket No. 7109) for approval of an alternative regulation plan pursuant to 30 V.S.A. § 218d. On March 10, 2006, VGS filed revised tariffs (Docket No. 7160) reflecting a 16.7% increase in its rates, to take effect on April 25, 2006, and to be implemented on a service-rendered basis commencing on October 1, 2006 (Tariff

Filing No. 7591). On March 15, 2006, the Company filed a letter asking the Board to consolidate, for purposes of hearings and administrative efficiency, Docket Nos. 7109 and 7160.

On March 15, 2006, the Department, pursuant to 30 V.S.A. § 225, informed the Board that it had reviewed the tariff filing and recommended that an investigation be opened. By letter dated March 23, 2006, the Department supported the Company's request for consolidation of the proceedings, and on April 13, 2006, the Board consolidated the two dockets, suspended the Company's tariff filing and opened an investigation into VGS's proposed rate increase.

Throughout both dockets, the parties have engaged in discovery. On January 25, 2006 (in South Burlington), and May 4, 2006 (by interactive television from St. Albans and Williston), the Board held public hearings on the proposed Plan and rate change, respectively. No members of the public attended the May 4 hearing. The Board held a technical hearing regarding the Company's proposed Plan on June 5, 2006.

The Department and VGS engaged in settlement negotiations and reached a "bottom-line" settlement regarding the Company's cost of service ("COS") as reflected in a Memorandum of Understanding ("MOU")¹ filed with the Board on June 30, 2006. The Board held a technical hearing on the cost-of-service MOU on July 11, 2006. On August 10, 2006, the Board issued an Order in Docket No. 7160 approving the MOU filed by the Department and VGS regarding the Company's cost of service and a resulting change in rates.

Subsequently, the Department and VGS reached a settlement regarding the Company's proposed Alternative Regulation Plan (the "Plan")² as reflected in the Memorandum of Understanding filed with the Board on July 31, 2006 (the "July 31 MOU"), and attached hereto. On August 8, 2006, the Board asked the DPS and VGS to answer a series of questions regarding the July 31 MOU. The Department and VGS provided written responses to the questions on August 21, 2006, and this matter is now ready to be decided.

1. Cited as Exh. MOU.

2. Cited as Exh. PSB:MOU-2.

III. FINDINGS

Based on the petition, the supporting prefiled testimony and exhibits and the evidence received during technical hearings, we hereby make the following findings of fact.

1. Vermont Gas is a "company" within the meaning of Section 201 of Title 30 of the Vermont Statutes Annotated, it transmits and distributes natural gas within the meaning of subsection (2) of Section 203 thereof and, as such, it is subject to the Board's jurisdiction. Pet. at 1.

2. Vermont Gas has petitioned the Board for approval of an alternative regulation plan (the "Plan") under 30 V.S.A. § 218d. See Pet. at 1.

The Plan

3. The Plan will commence on October 1, 2006, and will have an initial term of three years that expires on September 30, 2009; it can be extended for two successive, two-year terms; but it will not continue in effect after September 30, 2013. Exh. PSB:MOU-2 at 1.

4. Although the Company's rates will still be based on its cost of service (or "COS"), the Plan's objective is to regulate VGS's rates via the Plan's provisions rather than through litigated, COS investigations. Exh. PSB:MOU-2, ¶ 2b; Simollardes pf. at 3 (11/7/05).

5. Under the Plan, the Company is entitled to set rates based on the revenue required to recover its COS based on traditional ratemaking principles, but the Plan includes a proposed "Purchased Gas Adjustment" clause ("PGA") and a proposed Earnings Sharing Mechanism ("ESM"). Exh. PSB:MOU-2 at 2.

Purchase Gas Adjustment Clause (PGA)

6. Under the PGA, the Company's actual gas costs will be recovered quarterly, but the "Adjustment" includes a "deadband", a mechanism that excludes the first \$50,000 of such costs, positive or negative, in each quarter; a sharing band that increases or decreases rates to share 90% of the gains or losses (as the case may be) that exceed this "deadband;" and a cap on such gains and losses through the ESM. Exh. PSB:MOU-2, attachments 1 & 2; MOU at 1b-d.

7. Under the Plan, each quarter VGS will notify the Board and the Department (no later than the fifth-to-last business day of the month) of the PGA adjustment (if any) to be made beginning two months hence. Exh. PSB:MOU, ¶ 4a.

8. The Parties have agreed that the PGA will be amended by VGS, after review and with the advice of the Department, to provide greater specificity regarding the methods and sources employed in developing the adjusted test year's COS; the amended PGA shall be filed with the Board within thirty days of the July 31 MOU's approval. Exh. PSB:MOU-2, ¶ 11; MOU ¶ 1e.

9. If the Company alters the methods or sources for calculating the 12-month costs during the Plan's term, the Company will review the changes with the Department and subsequently file an amended PGA with the Board for its approval; should the Department have any changes to the Company's proposal to amend the PGA, the Department agrees to recommend those changes within three weeks of the Company's filing. Exh. MOU ¶ 1e.

10. The tariffs filed by the Company will unbundle the gas costs charged to firm customers to show the daily access charge, the gas cost per CCF charge and the distribution charge per CCF. Exh. PSB:MOU-2, ¶ 3c.

11. The Plan does not prevent the Department from asking for or the Board from initiating an investigation into the Company's gas costs and all other aspects of its COS. Exh. PSB:MOU-2, ¶ 4b.

Earnings Sharing Mechanism ("ESM")

12. The MOU provides VGS with the opportunity to recover operating and non-operating costs (i.e., non-gas costs) through an ESM, which includes a rate-setting formula. Exh. PSB:MOU-2, attachment 1.

13. The formula consists of three basic steps which require the determination of a Revenue Cap, Required Revenue and rates based on a comparison of the Required Revenue with the Revenue Cap. Exh. PSB:MOU-2, attachment 1.

14. The formula for setting authorized revenues to recover non-gas costs is :

$$REV_{At} = REV_{Ct} - (0.5 * (REV_{Ct} - REV_{Rt}))$$

Where: REV_A equals Authorized Revenue for rate year t.
 REV_C equals Revenue Cap for rate year t.
 REV_R equals Required Revenue for rate year t.

Exh. PSB:MOU-2, attachment 1; exh. MOU at 4, 5.

15. The MOU provides for an equal sharing between the Company and its customers of the difference between the revenue cap under the ESM and the Company's actual required revenue, as determined by traditional cost of service regulation methodologies. Exh. MOU at 5-6; exh. PSB:MOU-2, attachment 1.

16. Under the ESM, VGS's over-earnings and earnings losses are shared with customers in accordance with the terms and conditions of the attached MOU . Such sharing of over-earnings and earnings losses are capped at 200 basis points above or below VGS's allowed rate of return on equity ("ROE"). If over- or under-earnings diverge from the authorized ROE by 200 basis points, then such over- or under-earnings are to be fully reflected in firm rates. Exh. PSB:MOU-2, attachment 1.

17. Over-earnings or earning shortfalls, if any, shall be included in the annual determination of the revenue cap and presented as a separately identified "exclusion" item. Exh. PSB:MOU-2, attachment 1.

18. The operating-cost cap is based on the Company's growth in operating costs per customer between 1999 and 2004, which was .39 percent less than the consumer inflation rate, representing "productivity gains" that the Plan shares between customers and the Company. Exh. PSB:MOU-2, attachment 1.

19. The ESM also includes a "deadband" which prohibits increases or decreases in rates if VGS earnings exceed or fall below the Company's allowed ROE by 50 basis points. Exh. PSB:MOU-2, attachment 1.

20. For the purposes of determining the annual authorized revenue and the amount of over-earnings or earnings shortfall, if any, the authorized rate of return on equity is 10.50%. Exh. VGS-1a, schedule 11.

21. Under the Plan, no later than November 25 of that year VGS will notify the Board and Department of an increase or decrease (if any) in rates charged to firm customers to reflect changes in VGS's rates under the ESM. Exh. PSB:MOU-2, ¶ 5a.

22. The Plan requires the Company to provide notice to the Board and the Department 60 days before adjustment; the Plan further requires VGS to give individual notice to customers 30 days in advance of each such adjustment. Exh. PSB:MOU-2, ¶¶ 5a & 5b.

23. Annual adjustments will take effect on a bills-rendered basis and be effective for service rendered no earlier than sixty (60) days after the Company provides notice to the Board and Department. Exh. PSB:MOU-2, ¶ 5a.

24. The Company may also adjust its rates to recover exogenous costs actually incurred, such as changes in taxes or accounting rules, but only if such costs exceed \$50,000 in a given fiscal year. Exh. PSB:MOU-2, attachment 1; exh. MOU at 6.

Other Regulatory Requirements

25. The Plan requires that VGS continue its Service Quality and Reliability Plan ("SQRP"), and this plan has been amended to add a benchmark for processing demand-side management ("DSM") rebate checks. Exh. PSB:MOU-2, ¶ 6.

26. The Plan requires that VGS maintain its budgeted expenditures for DSM at the 2005-2006 level (adjusted for inflation). Exh. PSB:MOU-2, ¶ 7.

27. The Plan requires that VGS file tariffs offering interruptible service to large customers and industrial customers, which will replace special contracts currently used to provide these services. Exh. PSB:MOU-2, ¶ 8a.

28. The Plan requires that the Company file by January 31, 2007, a pilot tariff for the provision of fixed-rate service to up to thirty percent of its firm customers (including up to 30% of its residential customers). Exh. PSB:MOU-2, ¶ 8b.

Regulatory Filings

29. The Company will file annually with the Board and the Department (by July 1) its gas-supply plan for the gas year commencing on the next November 1; the Plan will include an

overview of the Company's strategy for procuring, storing, selling in wholesale markets and hedging the price of the gas required to serve its customers over a three-year period. Exh. PSB:MOU-2, ¶ 9a.

30. The Plan requires that the Company provide notice to the Board and Department on a quarterly basis, by the fifteenth of February, May, August, and November, of any changes to Vermont Gas' contracts for the supply, storage, transmission or hedging of its gas supply, or to its exchange rates. Exh. PSB:MOU-2, ¶ 9b.

31. VGS and the Department will meet annually (no later than March 15) to discuss the investments made by the Company in system expansion and the Company's preliminary plans for expansion in the then current calendar year. Exh. PSB:MOU-2, ¶ 10.

32. No later than October 30 and at least fifteen days before the Company's annual notice of changes to its rates under the Plan, the Company will meet with the Department to present the expected adjustment to rate base that will result from implementation of the Company's expansion plans for the current calendar year. Exh. PSB:MOU-2, ¶ 10b.

33. The Parties have agreed that if the MOU is approved, the number of customers added during the Plan's term will be presumed to be the number shown on Schedule 1 to the MOU, and have agreed to negotiate in good faith a different forecast of customers added if either party can demonstrate good cause therefor and that if the parties cannot agree on the forecast, the dispute will be submitted to the Board. Exh. MOU at 3a & 3c.

34. The Parties have agreed to jointly develop criteria to be used by VGS and the Department to assess the Plan's effectiveness at the end of its initial term; these criteria will be submitted to the Board on or before January 30, 2007, but will not bind either party to support termination or extension of the Plan beyond its initial term. Exh. MOU, ¶ 8.

Statutory Requirements

35. The Plan will result in a system of regulation in which the Company has clear incentives to manage its costs and provide least-cost energy service to its customers because the PGA and ESM will both contain "deadbands" and sharing bands that put the Company at risk of not recovering gas and other costs. Coyne pf. at 8-9 (11/7/05); Allen pf. at 9-10, 17-18 (3/10/06).

36. The Plan will provide just and reasonable rates for service to all classes of customers because the Plan is based on the Company's COS, and thus the underlying regulatory objectives of the Plan and traditional regulation are essentially the same. Simollardes pf. at 12 (11/7/05); Allen pf. at 18 (3/10/06).

37. Moreover, traditional ratemaking principles that underlie just and reasonable rates will continue to be applied under the Plan in determining the COS used to set rates. Exh. PSB:MOU-2, ¶ 3.

38. The Plan will result in safe and reliable service because the Company's SQRP will remain in effect, and the Company will continue to be at risk financially for failure to meet the SQRP's performance measures. Exh. PSB:MOU-2, ¶6.

39. By providing reasonable assurance through the PGA as to the Company's ability to recover gas costs – but placing the Company at risk through the "dead" and "sharing" bands, by allowing the Company to keep some of its earnings above the "deadband," and by requiring continued investment in DSM at current budgeted levels – the Plan offers incentives for innovation and improved performance, i.e., higher earnings if costs are managed well – that will help to advance state energy policy to promote affordable rates, investment in natural-gas-fired co-generation systems and continued investment in DSM. Exh. PSB:MOU-2; Simollardes pf. at 14 (11/7/05); Allen pf. at 2, 18 (3/10/06).

40. The Plan will promote improved quality of service, reliability and service choices because the Company's SQRP will remain in place, and add an additional performance measure for DSM rebate checks, and the Company will introduce a fixed-price service that, coupled with the PGA, will allow customers to choose between a fixed and variable rate. Simollardes pf. at 14-15 (11/7/05); Allen pf. at 19 (3/10/06).

41. The Plan will establish a reasonably balanced system of risks and rewards that encourages the Company to operate as efficiently as possible using sound management practices because it contains several mechanisms that allow the Company to keep some of the earnings over its allowed ROE but also to absorb certain earnings shortfalls; additionally, the Board retains its ability to review and investigate all aspects of the Company's COS. Simollardes pf. at 15 (11/7/05); Allen pf. at 9, 19 (3/10/06).

42. The Plan will provide a reasonable opportunity, under sound and economic management, to earn a fair rate of return and it provides effective financial incentives for the Company. Allen pf. at 20 (3/10/06); Simollardes pf. at 15 (11/7/05).

43. The Plan will allow savings to be shared with ratepayers because it includes an earnings-sharing mechanism and other features that will pass savings and a share of profits on to ratepayers. Exh. PSB:MOU-2, attachment 2; MOU at 1-3; Allen pf. at 20 (3/10/06).

IV. DISCUSSION AND CONCLUSION

The alternative regulation plan we adopt today provides for the recovery of prudently incurred costs through a Purchase Gas Adjustment clause or PGA, and an Earnings Sharing Mechanism, ESM. While the cost-recovery mechanisms operate independently of each other, we conclude that the PGA and the ESM in combination provide VGS with additional incentives to increase administrative and operational efficiencies. Thus, we find the amended alternative regulation plan to be consistent with the general good of the state, and the requirements of 30 V.S.A. § 218d.

Under the terms of the amended plan, VGS will be allowed to adjust firm rates each quarter to reflect changes, either increases or decreases, in the cost of purchased gas in a timely manner. With such timely and more frequent adjustments, VGS' access to lower cost capital should increase as investors perceive VGS to be a lower-risk investment.

The amended plan also provides VGS with the opportunity, under the ESM, to recover operating and non-operating costs based on an annual comparison of VGS' revenue cap with its required revenue. Under both of these cost recovery mechanisms, VGS has the incentive to actively manage its gas costs and improve operating efficiencies by retaining profits within narrowly prescribed "deadbands" for purchased gas and by sharing its earnings with customers. Over time, the effect of such incentives should result in a significantly higher productivity factor, lower capital costs and, lower firm rates than would be the case under traditional regulatory methods.

The Parties have agreed to develop, and submit by the end of January 2007, criteria to be used by VGS and the Department to assess the Plan's effectiveness at the end of its initial term.

Parties should include in their development of these criteria similar measures for assessing the effectiveness of the Plan upon VGS' system expansion, i.e., VGS' improvement of the system beyond the existing footprint into communities that are presently unserved by natural gas. We note that, while the MOU envisions a cooperative effort on the part of VGS and the Department, if the joint development of these criteria is ultimately not undertaken, then VGS and the Department shall each submit their own proposals by the end of January 2007.

Finally, the Department and Board retain the authority to investigate Vermont Gas' COS, and the Board retains its authority to issue an order disallowing costs from rates.

In sum, for these reasons and based on the findings we have detailed in this Order, and taking into account the statutory criteria of 30 V.S.A. § 218d, we conclude that the Plan should be approved.

One additional note, in the letter of August 28, 2006, which accompanied the "Joint Proposal for Decision," VGS indicated that VGS and the Department could not agree on one remaining issue. VGS and the Department are not in agreement as to whether, under the Plan, VGS should be able to continue to maintain an Account Correcting Efficiency ("ACE") for demand-side-management ("DSM") programs offered after the effective date of the Plan. VGS asks that ACE continue, whereas the Department takes the position that ACE should not be allowed under the plan.

The Board is interested in knowing more about the parties' positions on this issue, and also on the larger question of whether VGS should continue to administer its DSM programs or whether that function should migrate to Vermont's Energy Efficiency Utility, as it has for the majority of Vermont's electric utilities. Parties shall provide comments on these issues by close of business October 13, 2006.

V. ORDER

IT IS HEREBY ORDERED, ADJUDGED AND DECREED by the Public Service Board of the State of Vermont that:

1. Effective October 1, 2006, VGS may implement the Plan filed with the Board on July 31, 2006.

2. The Memorandum of Understanding between VGS and DPS, dated as of July 28, 2006, and filed with the Board on July 31, 2006, is hereby approved.

3. VGS shall submit a sample of each filing due to be made to the Department of Public Service or the Board under the terms of the Plan within 30 days of this Order as well amendments to its tariffs implementing the Plan.

4. VGS shall file with the Board the criteria to evaluate the Plan's effectiveness, including the effect of the plan upon system expansion, on or before January 31, 2007.

5. VGS shall notify the Board within 90 days of this Order of any proposed changes to its hedging strategy.

6. By the close of business October 13, 2006, the Parties shall file comments regarding their positions with respect to the treatment of ACE, and whether VGS should continue to administer its DSM programs.

Dated at Montpelier, Vermont, this 21st day of September, 2006.

<u>s/ James Volz</u>)	
)	PUBLIC SERVICE
)	
<u>s/ David C. Coen</u>)	BOARD
)	
)	OF VERMONT
<u>s/ John D. Burke</u>)	

OFFICE OF THE CLERK

FILED: September 21, 2006

ATTEST: s/ Susan M. Hudson
Clerk of the Board

NOTICE TO READERS: This decision is subject to revision of technical errors. Readers are requested to notify the Clerk of the Board (by e-mail, telephone, or in writing) of any apparent errors, in order that any necessary corrections may be made. (E-mail address: psb.clerk@state.vt.us)

Appeal of this decision to the Supreme Court of Vermont must be filed with the Clerk of the Board within thirty days. Appeal will not stay the effect of this Order, absent further Order by this Board or appropriate action by the Supreme Court of Vermont. Motions for reconsideration or stay, if any, must be filed with the Clerk of the Board within ten days of the date of this decision and order.