BEFORE THE NORTH CAROLINA UTILITIES COMMISSION **FILED**

Docket No. G-5, Sub 495

OCT 06 2008

Clerk's Office
N.C. Utilities Commission

In the Matter of

Application of Public Service Company of North Carolina, Inc. for a General Increase in its Rates and Charges

ATTORNEY GENERAL'S BRIEF

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Introduction and Summary

The Attorney General's Office ("AGO") files this Brief in opposition to the proposal of Public Service Company of North Carolina , Inc. ("PSNC" or the "Company") to create a rate adjustment mechanism called the "Customer Usage Tracker" or "CUT." According to legislation passed in 2007, the Commission may allow the CUT only upon findings that the mechanism is appropriate and in the public interest. N.C.G.S. § 62-133.7 (2008). PSNC has not shown that the mechanism proposed in this case is appropriate and in the public interest and the proposal therefore should be rejected.

In today's economy, residential and commercial consumers are struggling to pay their bills and keep their houses and businesses. Now is not a good time to transfer risks and impose burdens on them without a strong showing of need. The CUT should not be created for the following reasons:

- First, the proposed tracker mechanism is overly broad as a tool for stabilizing revenues. It guarantees *full* recovery of PSNC's margin from residential and commercial customer classes without regard to volumes sold, thereby transferring considerable risk to customers without corresponding benefit. During a three year experiment in which Piedmont Natural Gas Company (Piedmont) has been allowed to operate a similar tracking mechanism, over $94 million in revenue deferrals have occurred at significant cost to affected customers The revenue stability provided by the mechanism exceeds what is required or valued even by knowledgeable investors, and the benefit to the Company is not justified given the harm to consumers from frequent unsupervised rate adjustments, from the upward pressure that will be placed on rates, and from other concerns detailed herein.

- Second, the proposed tracker is not tailored to encourage effective utility-sponsored energy conservation programs. Other incentives for utility programs are likely to be more effective and less costly.

For these and other reasons described herein, the CUT mechanism should be rejected as it is now proposed. If the Commission concludes from its review of the evidence that PSNC's revenues would be inadequate unless risks relating to changes in usage are shared with customers, then a *partial* true up can be tailored to better fit the need.

What the CUT Is and How It Works

The purpose of the CUT mechanism is to address how PSNC recovers margin revenues from residential and commercial[1] customers. Margin revenues are all revenues except for those associated with the cost of gas.[2] Under the CUT, customers pay for service partly in a monthly facilities charge and partly in a volumetric (per therm) charge, but PSNC is guaranteed a fixed revenue per customer per month as if all revenues were recovered in the monthly charge. To the extent that residential and commercial customer classes use more or less natural gas than the amount guaranteed by the CUT, PSNC records the revenue difference in a deferred account, and the balance in the deferred account is recovered later through semiannual temporary adjustments to the volumetric charge. Thus, PSNC's investors are shielded from the risk associated with any decline in sales volumes and instead customers shoulder the risk through semiannual rate adjustments.

Under the Stipulation, customers will be charged the following rates for margin:

Residential	\$10/month	+	\$0.35678 per therm
Commercial	\$17.50/month	+	\$0.25160 per therm

Attorney General Cross Examination Exhibit 1.1.

The CUT guarantees PSNC that residential and commercial classes will use certain volumes of natural gas each month and thus will produce the following margin revenues per customer from volumetric and fixed monthly charges (reflecting the average monthly amounts over the course of the year):

Res'l	\$10/month (facilities charge)	+	\$19.59/month (per therm rate plus CUT)
Com'l	\$17.50/month (facilities charge)	+	\$71.79/month (per therm rate plus CUT)

Attorney General Cross Examination Exhibit 1, attached at Appendix p.1.

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[1] As used here, "commercial" refers to "Small General Service" or "SGS" customers served under Rate 125.

[2] Revenues associated with gas costs are already assured through a separate gas cost true-up mechanism. Gas cost adjustments occur periodically to track and true up changes in costs incurred by PSNC for fixed and commodity natural gas costs. N.C.G.S. § 62-133.4. PSNC does not make a profit on the gas cost part of its rates; rather the costs are flowed through to consumers. It is in PSNC's margin rates that PSNC has an opportunity to recover profits.

Each month, PSNC tracks the number of customers served and how much natural gas is actually used compared to the amount per customer predicted in the rate case. To the extent that guaranteed usage exceeds the actual usage, PSNC records the amount in its deferred account. Likewise, if guaranteed usage is less than actual usage, the amount is tracked. Stipulation Exhibit E (Rider C) p .20. In addition, interest is applied at the Company's authorized overall rate of return. Stipulation Exhibit E (Rider C) p. 21.

Under the CUT, rate adjustments occur on April 1 and October 1 of each year to refund or recover the balance in the deferred account. To implement the adjustment, the Company is required to file revised tariffs for Commission approval upon 14 days notice. For example, PSNC may file revised tariffs for Commission approval and a copy of related CUT adjustment computations on or before March 17 in order to adjust rates on April 1. Stipulation Exhibit E (Rider C) p. 21.

<u>**Questions Presented By the CUT Proposal**</u>

Two questions are presented:

1. Is it in the public interest to adopt the CUT mechanism as proposed, so that rates are adjusted twice annually according to a formula that provides for a true up based on average per-customer consumption, in order to guarantee that PSNC recovers all margin revenues based on the number of residential and commercial customers it serves without regard to how much natural gas is used by those classes?

2. If the adoption of a usage adjustment mechanism is found to be in the public interest, is the CUT mechanism designed appropriately to function as intended?

<u>**The Legal Standard for Consideration of the CUT Proposal**</u>

This case and the proposal of Piedmont Natural Gas Company (Piedmont) in pending docket No. G-9, Sub 550 present the first applications for adoption of rate adjustment mechanisms pursuant to N.C.G.S. § 62-133.7, a provision that was enacted in 2007. The new statute authorizes the Commission to approve the creation of a CUT-type mechanism that tracks and trues up gas utility rates for variations in average per customer usage. Pursuant to § 62-133.7, a usage rate adjustment mechanism must be adopted in a general rate case, must apply only to non-industrial rate schedules, and may be adopted

> *only* upon a finding by the Commission that the mechanism is appropriate to track and true up variations in average per customer usage by rate schedule from levels adopted in the general rate case proceeding and that the mechanism is in the public interest.

Id. (2008)(emphasis added). The burden of proof is on the utility. N.C.G.S. § 62-75.

The first part of the standard under the statute, whether a proposed mechanism is "appropriate," appears to require findings that the mechanism will function properly to obtain the intended result. That question becomes significant only if the Commission determines that it is in the public interest to adopt a mechanism.

The term "public interest" is not defined in the statute and should be viewed in the context of policies set forth in Chapter 62. The rates, services, and operations of public utilities are "affected with the public interest." N.C.G.S. § 62-2. Pursuant to G.S. § 62-110, PSNC has been granted a monopoly franchise to provide natural gas service within its service territories subject to regulation under Chapter 62. The primary purpose of the chapter is "to assure the public of adequate service at a reasonable charge." *State ex rel. Utilities Commission v. General Telephone Company of the Southeast*, 285 N.C. 671, 680, 208 S.E.2d 681, 687 (1974). Statutory provisions such as the ratemaking formula in N.C.G.S. § 62-133 and new § 62-133.7 are designed to provide the utility with adequate revenues, but not to "guarantee to the stockholders of a public utility constant growth in the value of and in the dividend yield from their investment." See *id.*

The Commission approved the adoption of a CUT mechanism that is essentially the same as the one proposed in this case in a Piedmont general rate case in 2005. (T p. 221) *"Order Approving Partial Rate Increase and Requiring Conservation Initiative,"* issued November 4, 2005, in Docket No. G-9, Sub 499 (*"2005 Piedmont Rate Case Order"*), pp. 19-26. The mechanism was approved as a three-year experiment, and the Commission expressed the intent to study the mechanism prior to deciding whether it should be adopted as a permanent tariff. *Id.* p. 24. At the time, the express statutory authority for adoption of the mechanism now found in N.C.G.S. § 62-133.7 did not exist, and two Commissioners dissented from the decision on policy and/or legal grounds.

Two chief policy objectives that influenced the *2005 Piedmont Rate Case Order* are relevant as the Commission considers the CUT proposal in this case. First, the CUT was approved in order to shield Piedmont from the impact of decreased volumetric consumption. The Commission observed that Piedmont's margins were likely to be burdened in response to natural gas prices that had reached unprecedented high levels during the fall of 2005 because its rates have a high volumetric component and most margin costs are fixed. Second, the Commission approved the CUT in order to encourage the development of energy conservation programs that would help consumers respond to high prices. The Commission recognized that approval of the CUT would allow rate adjustments based on a single element of rates without consideration of other countervailing elements, but found that circumstances justified adoption of the CUT on an experimental basis. In addition, the Commission found that the CUT would reduce shareholder risk in two ways: first, by providing for rate adjustments based on changes in usage without resort to a rate case, and second by avoiding unpopular increases in the fixed monthly charge. Given the reduced shareholder risk associated with the CUT, the Commission found that adoption of the mechanism was fair to consumers only if they realized a distinct benefit, and ordered the initiation of utility-sponsored energy conservation programs funded by Piedmont with $500,000 in contributions each year during the CUT experiment.[3] *Id.* pp. 23-24.

The policy factors considered and balanced by the Commission tie back to the primary purpose of Chapter 62: that is, "to assure the public of adequate service at a reasonable charge." 285 N.C. at 680; 208 S.E.2d at 687.

ARGUMENT

I. PSNC Has Not Shown That Adoption of the CUT Proposal Is In the Public Interest.

The chief reasons for adoption of the CUT as an experimental rate adjustment mechanism – its impact on revenue stability and on energy conservation – are not justification for continuation of the broad rate adjustment mechanism in the form of the CUT.

A. The CUT Uses an Overly Broad Tool to Address Revenue Stability and the Benefit to the Company Is Not Justified Given the Detriments to Consumers

PSNC argues that adoption of the CUT is justified because it addresses the need for revenue stability. The AGO disagrees that it is in the public interest to allow routine rate adjustments in order to provide for full recovery of margin revenues based on customer count without regard to volumes used. If the Commission concludes that the volumetric margin charges proposed in the Stipulation pose too much risk to the Company without some form of adjustment, then that conclusion is justification for a determination of how the risk must be shared with customers to provide for adequate revenues. It does not justify completely eliminating risk to the Company associated with reductions in sales volumes by shifting the risk to customers as is proposed in the CUT.

1. The CUT would transfer significant risk from PSNC's investors to its customers and PSNC has not shown that a full true up of rates is needed based on changes in usage.

The CUT shifts all risks associated with declines in natural gas consumption by residential and commercial customers from PSNC's shareholder to its customers. (T pp. 166-67) PSNC contends that the CUT is beneficial because it makes revenues more

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[3] In addition, Piedmont agreed to contribute additional funding in the amount of $750,000 per year under a subsequent settlement reached with the Attorney General.

stable and reduces the need for general rate cases. (Wright pre-filed testimony p. 8) However, from the perspective of consumers, the CUT increases the variability of rates, making rates less stable. It allows rate changes twice per year, and does not even limit the amount by which rates may increase. Stipulation Exhibit E (Rider C).

PSNC also contends that it is a benefit to customers that the CUT would replace the Weather Normalization Adjustment (WNA). (Wright pre-filed testimony p. 8) However, that benefit is illusory, because the CUT allows much broader and larger rate adjustments than the WNA. Whereas the WNA adjusts rates based on changes to usage prompted by variations in weather during winter months, the CUT would adjust rates for *all* changes in usage, including changes prompted by weather, price sensitivity, economic downturn, energy conservation, or any other factor. Stipulation Exhibit E (Rider C) (T pp. 197-99) The CUT may smooth out the impact of rate adjustments as compared to the WNA, because CUT adjustments would occur every six months instead of every winter month. However, the WNA could be designed to provide the same deferral of recovery as is proposed in the CUT if that is found to be desirable. The Commission may determine, though, that the timing of WNA adjustments is more favorable to customers because WNA credits occur in months when consumption is higher than normal and WNA charges occur in months when consumption is lower than normal. That means that, although the WNA adjustment is variable, its impact on bills has a moderating effect. The long deferrals allowed in the CUT mechanism postpone revenue recovery and impose more costs during months when consumption is higher, tending to exaggerate rather than moderate the variability of charges. (T pp. 197-99) Thus, the CUT mechanism may be considerably more burdensome for customers than the WNA.

Furthermore, PSNC has not shown that it is fair to shift the entire burden of reduced sales volumes to PSNC's customers. It is not atypical for a business to see a decline in revenues when market conditions become unfavorable and sales volumes decline. The effect of decreased sales volumes on revenues is a normal business risk that tends to encourage economizing measures. Such declines are offset by other times when sales volumes increase revenues. PSNC is the primary source of information, including usage predictions, used to establish the rates that apply. Yet, the CUT would shield PSNC from any impact to its margin related to variations in usage. (T pp. 166-67) The entire impact would be shifted to customers.

It was demonstrated during Piedmont's CUT experiment that the amount of revenues deferred for recovery from future customers may be large and may prompt large rate increases for consumers. See Attorney General Cross Examination Exhibit No. 4. A large decrease in usage began just as Piedmont's experiment began in 2005, and large revenue deferrals occurred. Over the course of the three-year experiment, the deferrals amounted to over $94 million. The balance in the CUT account, which is over $41 million, represents a significant burden on future customers related to revenues from past periods. Attorney General Cross Examination Exhibit No. 4.

Absent the CUT, Piedmont could have addressed the change immediately by filing an application for a general rate case. Had that occurred, other factors such as cost allocations could have been adjusted for the change in volumes, and other factors offsetting the need for the increase would have been taken into account. (Some common costs are allocated among customer classes based in whole or in part on normal volumetric consumption.) (T p. 219-20) Piedmont could have sought an interim increase, if needed. Instead, the change in volumes was addressed through the CUT mechanism by deferrals relating to the change in usage. As a result, for three years the CUT shifted the recovery of revenues attributable to past periods onto Piedmont's current customers, and the amount in the CUT balance continued to grow. Rate increases to cover CUT deferrals resulted in CUT collections of $53.4 million as of May 31, 2008 and the balance was $41.4 million. Attorney General Cross Examination Exhibit No. 4.

While a rate adjustment mechanism such as the CUT is sometimes justified to address an element in rates that is volatile and unpredictable, i.e., by allowing the Commission to establish a formula rate for that element in a general rate case, *State ex rel. Utilities Commission v. Edmisten,* 291 N.C. 327, 344, 230 S.E.2d 651, 661 (1976), the Piedmont CUT experiment does not support that justification. During the experiment, the amount of deferrals recorded each year was almost the same: $30 million. Attorney General Cross Examination Exhibit No. 4.

2. <u>The broad CUT mechanism is not required to attract investors</u>.

Moreover, PSNC's witnesses have not shown that investors demand or value the broad mechanism proposed in the CUT. Mr. Addison did not identify a value for the CUT proposal and did not distinguish its value from other partial true-up mechanisms. He indicated that although the CUT addresses the risk of future declining usage per customer, it would "not affect the principal risk factors that PSNC Energy faces today, which include risks due to the volatile capital markets, increasing capital demands and operating costs, a rapidly expanding service territory, volatile gas supplies and costs, and the overall economic uncertainty that our nation finds itself in today. (Addison pre-filed testimony p. 6) He went on,

> The feedback I have received in my discussions with financial analysts and other members of the investment community has been consistent. The investment community does not perceive the CUT as a major development for PSNC Energy from a risk or market perception perspective. While investors see the CUT as a valuable tool for supporting energy conservation, they do not believe that it will reduce overall risks that the Company faces based on the factors I discussed above. From the investors' perspective, the CUT is similar to a weather normalization adjustment and other rate stabilization programs which have become standard in the industry. In investors' view, the filing of the CUT does not significantly differentiate PSNC Energy from other companies in which they

> may invest. I would not expect the approval of the CUT alone to impact investors' perceptions of the overall risk faced by PSNC Energy.

Id.

Since the CUT is designed chiefly for the benefit of shielding PSNC's investors from the impact of reductions in usage on revenues and earnings, a lack of evidence showing that investors put much value on the CUT or value the broad true up more than a partial true up mechanism makes it less than clear that the broad mechanism is justifiable.

3. <u>The CUT does not just stabilize revenues; it is a tool that promises to grow revenues.</u>

PSNC has emphasized that the purpose of the CUT is to moderate revenues, but another benefit that the CUT offers to PSNC is that it will grow revenues over time. PSNC's customer base has experienced strong growth. (Harris pre-filed testimony p. 2; T p. 177) The decline in usage referred to by PSNC is a decline in *per customer* usage, (Harris pre-filed testimony p. 5) that may be offset by growth in customer count. Indeed, PSNC's projections for the rate case include an increase to total normalized volumes, not a decrease. (T p. 176) Paton Exhibit 8.

To the extent that PSNC is allowed to recover revenues based on the number of customers it serves and is shielded from the effect of declining per-customer consumption, its prospect for revenue growth is greatly enhanced. The adoption of the CUT allows PSNC to capture all growth from increases in the number of customers it serves and shield itself from the full impact of decreasing per customer consumption. See Attorney General Cross Examination Exhibit No. 2. The CUT trues up rates on a *per customer* basis, which means that PSNC is guaranteed revenues that reflect the amount of volumes projected in the rate case for each affected class *plus* additional volumes that are attributable to customers added after the rate case. For example, if PSNC experiences 4% growth in the number of customers it serves, then the CUT will compare actual usage to "normal" usage that is 4% greater than the volumes identified for the class in the rate case. The effect of this is demonstrated in Attorney General Cross Examination Exhibit No. 2, which shows an increase in guaranteed revenues over three years as follows:

Margin revenues from residential customers guaranteed by the CUT:

Year 1 (rate case)	$ 99.8 million
Year 2 (4% annual growth in customers)	$103.8 million
Year 3 (4% annual growth in customers)	$107.9 million

See Attorney General Cross Examination Exhibit No. 2. Thus, assuming 4% annual growth in customer base, the revenue increase over two years in "normalized" or guaranteed margins would be 8.16%, and rate increases would occur to assure recovery of $107.9 million in revenues by year 3. That is $8.1 million more than the volumetric rate was designed to recover from that class in the rate case.

4. Customers do not receive a benefit from the CUT proposal.

When Piedmont's CUT proposal was approved as an experiment in 2005,the Commission found that the CUT resulted in reduced shareholder risk, and in order for adoption of the mechanism to be fair to consumers, consumers needed to realize a distinct benefit. Therefore, the Commission ordered the initiation of utility-sponsored energy conservation programs funded by Piedmont. *2005 Piedmont Rate Case Order* p. 24. Such a benefit is not proposed in this case either in the form of program funding or otherwise. PSNC has not offered to contribute funding for conservation programs. Instead, customers would pay $750,000 per year in rates for PSNC to conduct such programs. Stipulation p. 7. No other benefit is offered to customers as an offset to the transfer of risk that occurs in the CUT mechanism.

The Stipulation seems to indicate that the rate of return in the Stipulation was lowered as a result of the agreement to create the CUT. It states, "[T]he [10.6%] stipulated return on common equity is lower than what the Company would otherwise have agreed to had the Stipulating Parties not agreed, among other considerations, to the implementation of the Customer Usage Tracker mechanism." Stipulation p. 5. According to this, the CUT *and other considerations* affected the stipulated ROE; no particular value was put on the impact of the CUT. Placing any significant value would not consistent with Mr. Addison's testimony that the approval of the CUT would not, by itself, impact investors' perceptions of the overall risk faced by PSNC Energy. (Addison pre-filed testimony p. 6)

Furthermore, the notion that customers will benefit from a reduced rate of return as a *quid pro quo* for the CUT mechanism is not supported by the amount of the stipulated rate of return on equity compared to what has been authorized for other natural gas utilities in recent published cases. A list of the authorized returns for other natural gas utilities published in the *Quarterly Review* indicates that the 10.6% ROE stipulated to by PSNC is within the range of returns allowed in other cases, and higher than many. See Attorney General Cross Examination Exhibit No. 8. Further, the revenue requirement would have been reduced more by the change in ROE if the capital structure had not been changed in an offsetting direction. (T Vol 2 pp. 23-25)

5. The CUT does not provide sufficient safeguards.

When rates are adjusted semiannually to recover the CUT deferred account balance, other factors affecting the need for the adjustment, such as other expenses or the rate of return at the time, are not examined. (T pp. 168-70) In fact, during

Piedmont's CUT experiment, CUT increases were allowed without scrutiny even at times when *Quarterly Review* reports published by the Commission indicated that Piedmont was exceeding its authorized rate of return. See Attorney General Cross Examination Exhibit No. 6; Attorney General Late Filed Exhibit 2, which show that, at the times that the CUT adjustment was allowed in November 2007 and April 2008, *Quarterly Review* reports indicated that Piedmont's rate of return had exceeded the authorized return for several successive quarterly review periods. Piedmont has since revised some of the data relied on in the preparation of some of the *Quarterly Reviews*, and the revised data significantly reduce some of Piedmont's earnings figures. Attorney General Late Filed Exhibits 1 and 2. However, Piedmont did not revise the data until after April 1, the last time that a CUT adjustment was approved.

Indeed, Commission scrutiny of adjustments is cursory under the CUT proposal. PSNC proposes to file requests for CUT rate adjustments 14 days in advance of the date the changes are to become effective. The requests must include the computations concerning changes in usage made under the CUT formula and tariffs reflecting the revised rates, but no information is required about other factors affecting the revenue requirement or rates. Customer notice of CUT-related rate increases would be provided when the change is already effective. Stipulation Exhibit E (Rider C) p.21.

By comparison, in this general rate case PSNC filed a petition and testimony March 31, 2008, requesting a rate increase to provide additional revenue of $20.4 million applicable to all customer classes; the request was set for hearing; customers received notice; public hearings were held; and a comprehensive investigation was conducted by interested parties prior to the evidentiary hearing in August. All factors affecting rates and services were subject to review, not just the usage factor. In a Stipulation reached with other parties, PSNC settled for additional revenue of $9.1 million. PSNC has requested that the rates become effective November 1, and the petition is still pending. (T pp. 3-6)

The CUT does not provide a cap on the amount that rates may be adjusted or a trigger so that rates are adjusted only in order to address extreme changes. Periodic review is not required. Given that the CUT only addresses one element of rates and has a propensity to increase rates over time, at a minimum it would be advisable to limit the duration of the CUT mechanism to a period of years and require that it be terminated unless reauthorized in conjunction with a general rate case, as was done in Piedmont's last rate case. *2005 Piedmont Rate Case Order* p. 25. As presently proposed, the CUT may continue in effect indefinitely, allowing semiannual margin rate adjustments without provision even for periodic prudence review.

6. The CUT mechanism encourages cost shifting to Residential and Commercial classes.

With adoption of the CUT, PSNC would recover revenues from residential and commercial customers based on how many customers it serves, without regard to how much natural gas they use. (T pp. 166-67) Other customer classes would continue to pay for service largely through volumetric rates, and the disparity in risks may encourage the Company to seek revenues disproportionately from classes that are subject to the CUT.

7. <u>Removing all risk associated with changes in sales volumes may remove important incentives associated with the adequacy of service</u>

PSNC is a monopoly provider of essential service to residential and commercial customers. Decisions made by PSNC affect the adequacy of supply and service, and customers cannot go elsewhere when they need natural gas. It is worrisome for a monopoly to receive all compensation from some customer classes without regard to how much natural gas is delivered.

B. <u>The CUT Is Not Tailored to Encourage Effective Utility-Sponsored Energy Conservation Programs</u>.

PSNC also argues that adoption of the CUT is justified because it encourages the implementation of energy conservation programs. The AGO disagrees that the CUT is justified on that basis for the following reasons:

1. <u>The CUT is not well-tailored to true up rates for changes in margin that occur as a result of savings achieved through utility-sponsored energy conservation programs</u>.

PSNC witnesses claim that the CUT allows PSNC to encourage energy conservation through vigorous customer programs because it removes the negative impact on margins that would otherwise result from sales declines. (Harris pre-filed testimony pp. 5-6; Addison pre-filed testimony p. 6)

However, the CUT has not been designed to true up margins for changes in consumption that come about from utility-sponsored programs. Rather, the CUT addresses *all* changes in usage no matter the cause of the changes. Indeed, the CUT is not so much an incentive to encourage further energy conservation as it is a shield to protect PSNC from energy conservation that has occurred due to non-utility efforts such as changes in building codes and appliance standards. Moreover, the shield extends not just to energy efficiency but to reduced consumption due to price sensitivity, such as when customers stay cold because they cannot afford to pay for heat, or when they use less energy simply because the weather is warmer than normal. In fact, if decreased usage were caused by inadequate service, the CUT would shield the Company's revenues even then.

Because the CUT is designed to apply a true up for all changes in usage, the impact on rates from the mechanism is not likely to be proportionate to the energy conservation benefits achieved. Revenue deferrals and rate adjustments as large as those that occurred during the Piedmont CUT experiment ($94 million) may occur regardless of whether significant savings are achieved under utility programs. Attorney General Cross Examination Exhibit No. 4; Stipulation Exhibit E (Rider C).

PSNC does not have energy conservation programs at this time other than a financing program that includes as one component the opportunity to finance weatherization or high efficiency appliances. (T p. 7) PSNC does not have a track record and did not offer evidence of savings that have occurred under any existing measures.

PSNC originally proposed to spend $1.3 million on several programs and presented descriptions of the plans. (Wright pre-filed testimony pp. 8-13) However, the amount of funding in the Stipulation was decreased to $750,000 to fund the same programs. Stipulation p. 7. No specific proposals have been submitted to the Commission for review and approval. Instead, according to the Stipulation PSNC will seek approval of programs within 30 days of receiving the order in this case. Stipulation p. 7. Although PSNC has expressed good intentions about implementing programs quickly after the rate case is decided, (T p. 9) the new programs may take some time to get off the ground. Customers will begin assuming the full risk for decreases in consumption November 1 if the CUT is approved, long before savings from PSNC programs will begin to occur. Benefits to PSNC are front-loaded, and the incentive will not depend on the vigor or success of PSNC's programs.

In short, the CUT is not well-tailored to address the potential costs brought about by PSNC's conservation efforts or to reward PSNC for demonstrated conservation results attributable to its conservation programs. Other incentive methods could be developed that would be better tailored to fit that goal.

2. <u>Promotion of energy conservation and reduction in average per customer use do not necessarily go hand in hand.</u>

PSNC's argument that decoupling encourages PSNC to promote energy conservation relies on the flawed assumption that increased natural gas use coincides with inefficient use of energy. The direct use of natural gas for space heating and water heating (as opposed to use of electricity) may be more energy efficient and produce lower emissions, and use of natural gas as a fuel for automobiles may also be more energy efficient and better for the environment. (T pp. 166, 187-88) Yet those uses of natural gas would tend to *build* load, not reduce it. Hence, even if the CUT creates incentives for some beneficial programs by removing the link between revenues and sales volumes, it also removes incentives for other beneficial programs.

PSNC's argument also relies on the flawed assumption that decreased natural gas use per customer coincides with efficient use of energy. However, if PSNC is encouraged by the CUT to add customers who use natural gas only for fireplace logs, then per-customer consumption would decline but energy efficiency goals would not be furthered.

3. The public interest in energy conservation may justify funding through a rate component, but PSNC's programs should be monitored closely.

The Stipulation provides funding for energy conservation programs as an element of rates. The AGO supports the development of cost effective energy conservation programs. Such programs have been funded through rates in other states and have produced substantial savings for many customers over time. See, for example, the Iowa Utilities Board *Order Addressing Issues and Closing Docket in Re Inquiry Into the Effect of Reduced Usage on Rate Regulated Natural Gas Utilities* issued December 18, 2006, p. 3. The Commission may find that general benefits obtained from furthering energy efficiency goals are advanced by funding such programs.

If the Commission approves the funding of energy conservation programs in PSNC's rates, the AGO recommends that PSNC's efforts be closely monitored given the lack of experience and the lack of detail in the proposal. Incentives may produce more effective results but are likely to do so if the reward is based on demonstrated savings achieved.

In sum, PSNC has not shown that the CUT proposal is in the public interest because, on balance, the benefits of the CUT in the forms of revenue stability and energy conservation program incentives are not sufficient to offset the harm to consumers from frequent unsupervised rate adjustments, from the upward pressure that will be placed on rates, and from other concerns detailed herein. The proposed CUT mechanism guarantees *full* recovery of PSNC's margin from residential and commercial customer classes without regard to volumes sold, thereby transferring considerable risk to customers without corresponding benefit, and PSNC has not justified the need for full true-up of margin revenues based on changes in usage.

II. PSNC Has Not Shown That the CUT Mechanism Is Designed Appropriately.

If the Commission concludes that it is in the public interest to adopt a full or partial decoupling mechanism such as the CUT, it must also find that the proposed mechanism is "appropriate," i.e., that it will function properly to obtain the intended result. N.G.C.S. § 62-133.7. Piedmont's CUT experiment has presented a number of concerns about the way the CUT mechanism may operate.

First, there was considerable delay between the deferral and recovery of CUT amounts in Piedmont's experiment. Out of the total $94 million in CUT deferrals, a balance of over $40 million still exists. See Attorney General Cross Examination Exhibit No. 4. Under Piedmont's CUT, customers have been required to pay a significant charge related to utility revenue requirements from prior periods, and the amount of the charge has continued to grow. In PSNC's proposal, the mechanism presents the same method for deferring and recovering revenues and the same problems may arise.

Second, records in the Piedmont CUT experiment indicate that most revenue deferrals were recorded during winter months. See Attorney General Cross Examination Exhibit No. 4. However, the CUT rate increases approved in Commission orders issued during the Piedmont CUT experiment indicate that the increments in rates for recovery of the CUT balance increased in summer months and dropped back in some winter months. See Attorney General Cross Examination Exhibit No. 7. As a result, deferrals related to winter usage tended to increase rates for customers at other times of the year when natural gas tends to be used for different purposes. To the extent that summer users are more burdened, that result conflicts with policies that seek to favor usage that occurs at non-peak times. In PSNC's proposal, the mechanism presents the same method for deferring and recovering revenues and the same problems may arise.

Third, the CUT proposal does not provide sufficient safeguards or scrutiny of the need for adjustments. See e.g., N.C.G.S. § 62-133.4(c)(concerning annual gas cost proceedings). Given the potential magnitude of CUT adjustments, periodic review of the CUT should be required, and other safeguards are appropriate. In Piedmont's last rate case, the CUT was limited to a three year period after which it expired unless renewed in a general rate case. *2005 Piedmont Rate Case Order* p. 25. Such a requirement should be imposed in this case if the CUT is adopted.

Fourth, the notice to customers about CUT-related rate adjustments should be sufficient to allow customers to understand what the adjustment is for and to distinguish CUT adjustments from others such as those due to market changes in the cost of gas. Further, although ratemaking and tariff provisions are often complex, the CUT tariff is unnecessarily confusing.

In sum, for the reasons shown above, PSNC has not shown that the CUT proposal is appropriate.

Alternatives to the CUT Proposal

Other gas utilities in North Carolina have functioned without rate adjustments based on variations or changes in usage. Without such adjustments, greater risk is shouldered by the utility and its revenues are more variable, but many businesses face revenue cycles. Rates should be designed to provide adequate service at reasonable charges, not to guarantee growth in revenues. 285 N.C. at 680, 208 S.E.2d at 687.

If the Commission finds that rates are not designed to provide adequate revenues unless the revenues in the volumetric component are guaranteed to some extent, then that would justify a measure of risk sharing, not elimination of all risk associated with decreases in consumption. To that end, the Commission may allow revenue tracking as in the CUT proposal with partial true up of revenues so that risks are shared between the Company and its customers.

PSNC already recovers about 1/3 of its stipulated margin costs from residential customers through the $10/month fixed monthly charge (i.e., $10 out of $29.59 per month per customer on average over the course of the year). See Attorney General Cross Examination Exhibit No. 1, attached at Appendix p. 1. If the Commission allows a true up of half of the revenue per customer projected from the volumetric margin rate, then well over one half of PSNC's margin revenues would be shielded from changes in consumption, and the risk would be shared between PSNC and its customers. See Alternative to Stipulated Margin attached at Appendix p. 2. Other percentages or amounts could be used with the same tracking method.

The Public Utilities Commission of Colorado considered a proposed decoupling mechanism in a 2007 case, and made modifications to limit the impact of the mechanism. See *2007 Colorado Order* pp. 21-22. The commission observed that utilities operate more efficiently in response to business risk, and that declining per customer usage is offset by growth in the number of customers served, and so adopted the mechanism so that it would adjust rates but only to the extent that customer weather-normalized usage declines occur by more than a certain percentage per year. (The proposal did not have such a trigger.) Upon determining the extent to which a true up may occur, the commission directed the parties in the case to hold technical meetings to define the process in order to implement the modifications. *Colorado Order* p. 23.

Similarly, here, the Commission could define how risks should be shared and direct parties to work out the technical details. A partial adjustment mechanism would reduce PSNC's risk regarding customer usage, but not eliminate it, and would alleviate some of the concerns posed by a full adjustment mechanism.

CONCLUSION

PSNC has not shown that full true up of rates for changes in consumption is in the public interest or that the mechanism is appropriate. The benefits for the Company do not outweigh the detriments for customers and the harm to ratemaking. The proposal is not in the public interest and should be rejected.

Respectfully submitted this the 6th day of October, 2008.

ROY COOPER
Attorney General

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CERTIFICATE OF SERVICE

The undersigned certifies that she has served a copy of the foregoing ATTORNEY GENERAL'S BRIEF upon the parties of record in this proceeding and their attorneys by hand delivery or depositing a copy of the same in the United States Mail.

This the 6th day of October, 2008.

Margaret A. Force

Margaret A. Force
Assistant Attorney General

Attorney General Cross Examination Exhibit No. 1

Residential 101	Stipulation Revenues							
	Margin Volumetric Rate						Fixed Rate	Total Margin
	1	2	3	4	5	6	7	8
	Baseload th/mo	HSF th/HDD	normal DD	CUT Guaranteed th/customer	R value $/th	CUT Guaranteed $/customer/mo	$/customer/mo	$/customer/mo
January	8.53271	0.16651	724.084	129.1	0.35678	$46.06	$10.00	$56.06
February	8.53271	0.16651	583.065	105.6	0.35678	$37.68	$10.00	$47.68
March	8.53271	0.16651	448.837	83.3	0.35678	$29.71	$10.00	$39.71
April	8.53271	0.16651	201.387	42.1	0.35678	$15.01	$10.00	$25.01
May	8.53271	0.16651	61.333	18.7	0.35678	$6.69	$10.00	$16.69
June	8.53271	0.16651	5.502	9.4	0.35678	$3.37	$10.00	$13.37
July	8.53271	0.16651	0.229	8.6	0.35678	$3.06	$10.00	$13.06
August	8.53271	0.16651	0.093	8.5	0.35678	$3.05	$10.00	$13.05
Septem	8.53271	0.16651	21.253	12.1	0.35678	$4.31	$10.00	$14.31
October	8.53271	0.16651	186.939	39.7	0.35678	$14.15	$10.00	$24.15
November	8.53271	0.16651	419.112	78.3	0.35678	$27.94	$10.00	$37.94
December	8.53271	0.16651	690.849	123.6	0.35678	$44.09	$10.00	$54.09
Total	102.39252		3342.683	659.0		$235.11	$120.00	$355.11
Average				54.9		$19.59		$29.59

Small General Service 125	Stipulation Revenues							
	Margin Volumetric Rate						Fixed Rate	Total Margin
	Baseload th/mo	HSF th/HDD	normal DD	CUT Guaranteed th/customer	R value $/th	CUT Guaranteed $/customer/mo	$/customer/mo	$/customer/mo
January	115.15641	0.61089	724.084	557.5	0.25160	$140.27	$17.50	$157.77
February	115.15641	0.61089	583.065	471.3	0.25160	$118.59	$17.50	$136.09
March	115.15641	0.61089	448.837	389.3	0.25160	$97.96	$17.50	$115.46
April	115.15641	0.61089	201.387	238.2	0.25160	$59.93	$17.50	$77.43
May	115.15641	0.61089	61.333	152.6	0.25160	$38.40	$17.50	$55.90
June	115.15641	0.61089	5.502	118.5	0.25160	$29.82	$17.50	$47.32
July	115.15641	0.61089	0.229	115.3	0.25160	$29.01	$17.50	$46.51
August	115.15641	0.61089	0.093	115.2	0.25160	$28.99	$17.50	$46.49
Septem	115.15641	0.61089	21.253	128.1	0.25160	$32.24	$17.50	$49.74
October	115.15641	0.61089	186.939	229.4	0.25160	$57.71	$17.50	$75.21
November	115.15641	0.61089	419.112	371.2	0.25160	$93.39	$17.50	$110.89
December	115.15641	0.61089	690.849	537.2	0.25160	$135.16	$17.50	$152.66
Total	1381.87692		3342.683	3423.9		$861.45	$210.00	$1,071.45
Average				285.3		$71.79		$89.29

1 Baseload th/mo: See Stipulation Exhibit D
2 HSF th/HDD: See Stipulation Exhibit D
3 Normal degree day: See Paton Exhibit 9 p.2
4 CUT th/customer: Column 1 + Column 2 x Column 3
5 R value $/th: See Stipulation Exhibit D
6 CUT $/customer/mo: Column 4 x Column 5
7 Fixed Rate $/custoomer/mo: See Stipulation Exhibit D
8 Total Margin $/customer/mo: Column 6 + Column 7

PSNC Stipulated Revenues – Alternative

Residential 101								Fixed Rate	TOTAL Guaranteed	TOTAL Margin
	Margin Volumetric Rate									
	1	2	3	4	5	6	7	8	9	10
	Baseload th/mo	HSF th/HDD	normal DD	Projected th/customer	R value $/th	Projected $/customer/mo	Guaranteed $/customer/mo	$/customer/mo	$/customer/mo	$/customer/mo
January	8.53271	0.16651	724.084	129.1	0.35678	$46.06	$23.03	$10.00	$33.03	$56.06
February	8.53271	0.16651	583.065	105.6	0.35678	$37.68	$18.84	$10.00	$28.84	$47.68
March	8.53271	0.16651	448.837	83.3	0.35678	$29.71	$14.85	$10.00	$24.85	$39.71
April	8.53271	0.16651	201.387	42.1	0.35678	$15.01	$7.50	$10.00	$17.50	$25.01
May	8.53271	0.16651	61.333	18.7	0.35678	$6.69	$3.34	$10.00	$13.34	$16.69
June	8.53271	0.16651	5.502	9.4	0.35678	$3.37	$1.69	$10.00	$11.69	$13.37
July	8.53271	0.16651	0.229	8.6	0.35678	$3.06	$1.53	$10.00	$11.53	$13.06
August	8.53271	0.16651	0.093	8.5	0.35678	$3.05	$1.52	$10.00	$11.52	$13.05
Septem	8.53271	0.16651	21.253	12.1	0.35678	$4.31	$2.15	$10.00	$12.15	$14.31
October	8.53271	0.16651	186.939	39.7	0.35678	$14.15	$7.07	$10.00	$17.07	$24.15
November	8.53271	0.16651	419.112	78.3	0.35678	$27.94	$13.97	$10.00	$23.97	$37.94
December	8.53271	0.16651	690.849	123.6	0.35678	$44.09	$22.04	$10.00	$32.04	$54.09
Total	102.39252		3342.683	659.0		$235.11	$117.56	$120.00	$237.56	$355.11
Average				54.9		$19.59	$9.80	$10.00	$19.80	$29.59

Small General Service 125								Fixed Rate	TOTAL Guaranteed	TOTAL Margin
	Margin Volumetric Rate									
	Baseload th/mo	HSF th/HDD	normal DD	Projected th/customer	R value $/th	Projected $/customer/mo	Guaranteed $/customer/mo	$/customer/mo		$/customer/mo
January	115.15641	0.61089	724.084	557.5	0.25160	$140.27	$70.13	$17.50	$87.63	$157.77
February	115.15641	0.61089	583.065	471.3	0.25160	$118.59	$59.30	$17.50	$76.80	$136.09
March	115.15641	0.61089	448.837	389.3	0.25160	$97.96	$48.98	$17.50	$66.48	$115.46
April	115.15641	0.61089	201.387	238.2	0.25160	$59.93	$29.96	$17.50	$47.46	$77.43
May	115.15641	0.61089	61.333	152.6	0.25160	$38.40	$19.20	$17.50	$36.70	$55.90
June	115.15641	0.61089	5.502	118.5	0.25160	$29.82	$14.91	$17.50	$32.41	$47.32
July	115.15641	0.61089	0.229	115.3	0.25160	$29.01	$14.50	$17.50	$32.00	$46.51
August	115.15641	0.61089	0.093	115.2	0.25160	$28.99	$14.49	$17.50	$31.99	$46.49
Septem	115.15641	0.61089	21.253	128.1	0.25160	$32.24	$16.12	$17.50	$33.62	$49.74
October	115.15641	0.61089	186.939	229.4	0.25160	$57.71	$28.85	$17.50	$46.35	$75.21
November	115.15641	0.61089	419.112	371.2	0.25160	$93.39	$46.70	$17.50	$64.20	$110.89
December	115.15641	0.61089	690.849	537.2	0.25160	$135.16	$67.58	$17.50	$85.08	$152.66
Total	1381.87692		3342.683	3423.9		$861.45	$430.73	$210.00	$640.73	$1,071.45
Average				285.3		$71.79	$35.89	$17.50	$53.39	$89.29

1 Baseload th/mo: See Stipulation Exhibit D
2 HSF th/HDD: See Stipulation Exhibit D
3 Normal degree day: See Paton Exhibit 9 p.2
4 CUT th/customer: Column 1 + Column 2 x Column 3
5 R value $/th: See Stipulation Exhibit D
6 CUT $/customer/mo: Column 4 x Column 5
7 Fixed Rate $/custoomer/mo: See Stipulation Exhibit D
8 Total Margin $/customer/mo: Column 6 + Column 7