BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF DELAWARE

IN THE MATTER OF THE APPLICATION OF CHESAPEAKE UTILITIES CORPORATION FOR APPROVAL OF A CHANGE IN ITS GAS SALES SERVICE RATES ("GSR") TO BE EFFECTIVE NOVEMBER 1, 2008 (Filed September 2, 2008)	**PSC DOCKET NO. 08-269F** **PHASE II**

ORDER NO. 7778

FINAL FINDINGS, OPINION AND ORDER OF THE COMMISSION

BEFORE COMMISSIONERS:

Arnetta McRae, Chair
Joann T. Conaway, Commissioner
Jaymes B. Lester, Commissioner
J. Dallas Winslow, Commissioner
Jeffrey C. Clark, Commissioner

APPEARANCES:

For the Applicant, Chesapeake Utilities Company – Delaware Division ("Chesapeake" or the "Company")

WILLIAM A. DENMAN, ESQUIRE
Parkowski, Guerke & Swayze, P.A.

JENNIFER A. CLAUSIUS, Manager, Pricing & Regulation

For the Delaware Public Service Commission Staff ("Staff"):

REGINA A. IORII, ESQUIRE
Deputy Attorney General
Public Service Commission

For the Division of the Public Advocate ("Public Advocate"):

KENT WALKER, ESQUIRE
Deputy Attorney General
Division of the Public Advocate

PROCEDURAL HISTORY

1. On September 2, 2008, Chesapeake filed its annual application with the Commission seeking approval to decrease its Gas Sales Service Rates ("GSR") for all customer service classes effective on November 1, 2008. By Order No. 7446 dated September 16, 2008, the Commission permitted the proposed rate changes to go into effect on November 1, 2008, on a temporary basis, subject to refund pending full evidentiary hearings. The Commission further designated a Hearing Examiner to conduct the hearings and report to the Commission his proposed findings and recommendations based on the evidence presented.

2. The Hearing Examiner established a procedural schedule and scheduled an evidentiary hearing for May 28, 2009. The Public Advocate filed a statutory notice of intervention.

3. On January 8, 2009, Chesapeake filed a supplemental application seeking Commission approval of additional decreases to the GSR rates that were approved in Order No. 7446 because the projected under-collection exceeded the 6% threshold contained in Chesapeake’s Tariff Sheet 42. The Company also sought a waiver of the sixty (60) day notice requirement of 26 *Del. C.* §304(a) to allow the new rates to become effective with bills rendered on or after February 1, 2009. By Order No. 7521 dated January 29, 2009, the Commission permitted the proposed supplemental rate changes to become effective with service on and after February 1, 2009, on a temporary basis subject to true-up and refund pending full evidentiary hearings, and granted the requested waiver.

4. On May 28, 2009, the date of the noticed evidentiary hearing, the parties requested the Hearing Examiner to reschedule the hearing to allow them to continue to pursue promising settlement negotiations. The Hearing Examiner rescheduled the evidentiary hearing to June 11, 2009. At that evidentiary hearing, the parties submitted a proposed settlement agreement resolving all contested issues save one that arose late in the docket: whether the Company is providing pipeline capacity to its affiliate PESCO on terms and conditions consistent with applicable law, rules, and/or regulations (that is, whether, and if so, to what extent, asymmetric pricing principles apply for pipeline capacity released to PESCO to serve the Company’s former off-system sales (“OSS”) customers, and whether asymmetric pricing principles should apply in determining the amount of the credit to the GSR for pipeline capacity released to PESCO). The parties deferred this issue to a Phase II and proposed a procedural schedule, which the Hearing Examiner subsequently approved. Pursuant to that schedule, the Company submitted the prefiled direct testimony of Jennifer A. Clausius, its Manager of Pricing and Regulation, on June 29, 2009.

5. The Commission approved the proposed settlement in Order No. 7607 (July 7, 2009) and authorized this Phase II proceeding.

6. After a slight extension of the procedural schedule, Staff submitted direct testimony from Richard W. LeLash on August 4, 2009. On that same date, the Public Advocate submitted prefiled testimony

from Andrea C. Crane, President of The Columbia Group, Inc.[1] On August 18, 2009, the Company submitted rebuttal testimony from Ms. Clausius.

7. The Hearing Examiner conducted a pre-hearing conference with the parties on August 26, 2009. During this prehearing conference, the parties discussed with the Hearing Examiner whether an evidentiary hearing was necessary in light of the fact that the issues were purely legal ones that could be resolved solely on briefing. The Hearing Examiner directed the parties to discuss this among themselves and report back to him with their conclusion. After discussion, the parties advised the Hearing Examiner that they would submit the issue on briefs and that they would not conduct any cross-examination at the evidentiary hearing.

8. Also on August 26, 2009, Staff filed a motion to strike certain portions of the direct and rebuttal testimony of Ms. Clausius. The Company filed a response on August 28, 2009. Ultimately, Staff and the Company reached agreement on portions of Ms. Clausius' testimony to be stricken, and the Hearing Examiner entered an order striking the agreed-upon portions of the testimonies on September 1, 2009.

9. On September 2, 2009, the parties attended the scheduled evidentiary hearing for the sole purpose of making a slight correction to Ms. Clausius' rebuttal testimony and to admit the prefiled testimonies into evidence. After the close of the record, the parties and the Hearing Examiner established a briefing schedule. Pursuant to that schedule, the parties filed post-hearing briefs.

[1] Each of these witnesses also submitted prefiled testimony in Phase I of this docket.

10. On January 7, 2010, the Hearing Examiner issued his proposed findings and recommendations. Chesapeake filed exceptions to the Hearing Examiner's findings and recommendations. Neither Staff nor the Public Advocate filed exceptions, although Staff did note some factual corrections and clarifications that it believed were required.

11. The Commission convened at its regularly-scheduled meeting on February 18, 2010 to hear argument from the parties and to conduct public deliberations. After hearing argument from the parties and discussion among the Commissioners, the Commissioners voted unanimously to table the matter to the March 16, 2010 Commission meeting and to allow the parties to supplement their submissions with additional authority or argument.

12. On March 4, 2010, Chesapeake, Staff and the Public Advocate filed additional submissions with the Commission.

13. The Commission took this matter up again at its regularly-scheduled meeting on March 30, 2010. Again, it heard argument from the parties and conducted public deliberations. This is the Final Findings, Opinion and Order of the Commission reflecting its deliberations in this Phase II.

FACTUAL BACKGROUND

14. Chesapeake's Delaware Division provides service to some 38,300 customers located in southern New Castle, Kent and Sussex counties, approximately 91% of which are residential.[2] The Delaware

[2] The Delaware Division is one of three natural gas divisions. Chesapeake also provides service to Maryland's eastern shore and to several counties in Florida. (Exh. 22 (Crane) at 7).

Division is connected to only one interstate natural gas pipeline, its affiliate Eastern Shore Natural Gas Company ("ESNG"); there are no other interstate pipelines in the immediate vicinity through which Chesapeake can transport natural gas. The Delaware Division has transportation entitlements with ESNG which, in turn, are supported by upstream transportation entitlements and storage agreements. Hence, all gas delivered to Delaware Division customers flows through ESNG's pipeline. ESNG is regulated by the Federal Energy Regulatory Commission ("FERC"). (Exh. 22 (Crane) at 7).

15. The Company purchases firm, long-term pipeline capacity from ESNG at the maximum FERC-approved rates of approximately 30 cents per dekatherm ("Dth") for Delaware Zone 1 and approximately 56 cents per Dth for Delaware Zone 2 to serve its firm customers on a design day. (*Id*. at 2; Exh. 24 (Clausius-R) at 16). The Company charges the maximum FERC-approved rates of 30 cents per Dth for pipeline capacity releases to firm Delaware Zone 1 customers and 59 cents per Dth for pipeline capacity releases to firm Delaware Zone 2 customers. (Exh. 23 (LeLash) at 6).

16. In Docket No. 00-523, this Commission approved a settlement that, among other things, established a Cost Accounting Manual and a Code of Conduct for Chesapeake. (See Order No. 5828 dated Nov. 6, 2001). The following language of the Settlement Agreement in that case sets forth pricing principles to be applied to certain types of affiliate transactions in the future:

References to the exhibits introduced into the record will be cited as "Exh. __ (Witness' Name) at __" for direct testimony and "Exh. __ (Witness' name-R) at __" for rebuttal testimony.

> Pricing Principles. The Settling Parties agree that subject to the provisions set forth below, for transfer of assets between Regulated Activities ("Chesapeake") and Non-Regulated Activities, ("Affiliate") asymmetric pricing principles (i.e. for transfers from Chesapeake to the Affiliate, the higher of fully allocated cost or market price; for transfers from the Affiliate to Chesapeake, the lower of fully allocated cost or market price) shall apply. Asymmetric pricing principles shall also apply to the provision of services, exclusive of shared services or common support services, provided however that if the market price of such service is not reasonably ascertainable, fully allocated costs will be used.

(Paragraph II(10), Settlement Agreement in Docket No. 00-523 at 3).[3] Additionally, the settlement contained a provision that if Chesapeake decided to own and/or operate a marketing affiliate, or if its non-utility operations were selling natural gas in Delaware, the following Code of Conduct provisions would apply:

> The following Standards of Conduct shall apply to transactions between Chesapeake Utilities Corporation – Delaware Division, Non-Regulated Activities, and Third Parties.
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> * * *
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> 3. Chesapeake Utilities Corporation – Delaware Division or any Non-Regulated Activities may not represent that the utility will give any preference to a customer or others in the use of Natural Gas Distribution Utility Services as a result of that customer or others dealing with the Non-Regulated Activities.
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> 4. Chesapeake Utilities Corporation – Delaware Division may not give any preference to its Non-Regulated Activities or customers of its Non-Regulated Activities in the provision of Natural Gas Distribution Utility Services.

[3] The "provisions set forth below" are inapplicable here.

(General Standards or Codes of Conduct approved in Docket No. 00-523).

17. Prior to the Company's last base rate case (Docket No. 07-186), the Company had provided interruptible sales service to eleven off-system sales ("OSS") customers.[4] In Docket Nos. 07-186 and 07-246F (the GSR case immediately preceding the present docket), Chesapeake stated that it intended to stop making off-system sales. (*See* filings in those dockets; *see also* Exh. 22 (Crane) at 7). Chesapeake subsequently transferred its OSS customers to its affiliate, Peninsula Energy Service Company ("PESCO"), and began to release pipeline capacity to PESCO to enable PESCO to serve these customers. (Exh. 22 (Crane) at 7).

18. Prior to Chesapeake's announcement that it intended to cease making off-system sales, margins from the Company's off-system sales were shared between shareholders and ratepayers.[5] To alleviate concerns over the regulatory impact of Chesapeake's exit from its merchant function and the anticipated transfer of its OSS customers, the Company committed to credit the GSR for 100% of the revenues it received for any pipeline capacity released to serve the former OSS customers. The settling parties intended the credit to equal what would have been credited to Chesapeake's firm customers through the margin sharing mechanism had these OSS customers remained the

[4] As defined on page 7 of Ms. Clausius' Direct Testimony in Phase II of this case, "[a]n off-system sale in the natural gas industry is the sale of natural gas by a utility to a customer who is not directly connected to the utility's distribution system." (Exh. 21 (Clausius) at 7).

[5] According to Chesapeake, the Company shared approximately 41% of these margins, on average, based on the margin sharing mechanism then in effect. (Exh. 22 (Crane) at 7-8).

Company’s customers. (Settlement Agreement in Docket No. 07-246F at ¶11). (Exh. 23 (LeLash) at 2). This was consistent with the existing requirement that the Company credit 100% of ESNG pipeline capacity release revenues to the GSR since ratepayers pay for 100% of the cost of that pipeline capacity through the GSR. (Exh. 22 (Crane) at 8). The settlement in PSC Docket 07-246F did not require that the release rate be equal to the higher of “cost” or “market”. We approved the settlement in PSC Docket 07-246F in Order No. 7450 dated October 7, 2008.

19. In Phase I of this docket, the Company disclosed that it was charging PESCO 17 cents per Dth for the pipeline capacity it releases to PESCO and with which capacity PESCO supplies Chesapeake’s former OSS customers. (Exh. 23 (LeLash) at 2-3). In designing the rate, the Company divided $160,000 (the historical five-year average annual margins previously credited to firm customers when the Company was making OSS) by the number of Dths that the Company estimated PESCO would need to serve the OSS customers, and arrived at a rate of $0.17 per Dth. (Exh. 21 (Clausius) at 9). In Phase II of this docket, the Company presented the testimony of Jennifer Clausius that, in Docket 07-246F, the Company informed the parties that the historical five-year average of OSS margins credited to the firm customers totaled approximately $160,000 per year and that the Company would release capacity at a rate that would equate to a credit for capacity release revenue approximating the 5-year average annual margin share under the discontinued OSS program (Ex. 21 (Clausius) at 8).

20. FERC regulates the release of pipeline capacity on interstate pipelines. (See 18 C.F.R. Section 284.8). With respect to the $0.17 per Dth capacity release rate designed by the Company for capacity releases to PESCO, as allowed by FERC's capacity release rules, the Company entered into capacity release agreements with PESCO as a predesignated replacement shipper. Under FERC rules, the Company was required to post the $0.17 per Dth proposed rate on an electronic bulletin board, and provide other interested parties with the opportunity to submit competing bids. However, PESCO would have the right to receive all of the capacity, *provided* PESCO met the highest competing bid. (Exh. 21 (Clausius) at 13-14). (*See* 18 C.F.R. Section 284.8(e))

21. The Company credits all capacity release revenues to its Delaware firm customers through a reduction in the cost paid by the Company to ESNG. PESCO does not pay any sums to Chesapeake. (Exh. 21 (Clausius) at 12-13). In accordance with ESNG's FERC-approved tariff rules, PESCO pays ESNG directly for the capacity. For the twelve-month period ending December, 2008, the actual GSR credit for capacity released to PESCO was $198,880. For the five-month period ending May, 2009, the GSR credit was $189,343. (Exh. 21 (Clausius) at 13).[6]

THE PARTIES' CONTENTIONS

A. Chesapeake.

[6] The Company contends that Staff and the Public Advocate incorrectly include the commodity cost of approximately 2 cents per Dth in the 59-cent Zone 2 rate. Since the commodity rate is not charged on the pipeline capacity releases to PESCO, the appropriate maximum rate for Zone 2 would be approximately 57 cents. (Exh. 24 (Clausius-R) at 16-17).

22. Chesapeake contended that the Commission should reject Staff and the Public Advocate's contention that asymmetrical pricing is required for capacity releases to PESCO. First, the Company argued, the Commission-approved settlement in Docket No. 07-246F superseded the settlement agreement (and asymmetric pricing principles) approved in Docket No. 00-523. (Company Opening Brief at 7) (hereafter "COB at __")). In this regard, the Company contended that all of the parties to the Docket No. 07-246F settlement knew that Chesapeake intended to release capacity to PESCO at a rate that would equate to a credit for capacity release revenue approximating the five-year average annual margin share under the discontinued OSS program, and that, if the parties had intended to require that any capacity released to PESCO be at the higher of "maximum" rate or market rate, there would have been no need to "design" a credit that would approximate the historical annual average of $160,000 in margins that were credited to the firm ratepayers. (*Id*. at 6). Moreover, the Company argued, the capacity being released was not purchased to serve OSS customers and is not being purchased to sell to PESCO; rather, the Company must anticipate several years in advance what its firm customers' peak design day needs will be and then enter into long-term contracts for this capacity to ensure that the Company will have adequate capacity to serve its firm Delaware customers on a design day. (Company Reply Brief at 2) (hereafter "CRB at __")).

23. Second, the Company contended that Staff's and the Public Advocate's positions were inconsistent with the FERC's capacity release rules, which were designed to promote an efficient market free

of undue discrimination. In general, the rules require that a shipper wishing to release some of its firm capacity must post the capacity for bidding on the pipeline's electronic bulletin board, and the capacity must be awarded to the highest bidder meeting all of the conditions of the proposed release. When a releasing shipper, such as Chesapeake, enters into a capacity release agreement with a pre-designated replacement shipper (such as PESCO) the pre-designated replacement shipper will receive all of the capacity, *if and only if,* it meets the highest competing bid. (18 C.F.R. Section 284.8(e)) Thus, the Company argued, the bidding process, and hence the market, ultimately sets the rate. Preventing the Company from releasing capacity to PESCO at a rate below the maximum rate would discriminate against PESCO and provide PESCO's competitors with an unfair advantage, contrary to the FERC's pro-competitive, open access policies that favor granting released capacity to shippers based on market forces. (COB at 10-14). Citing *United Distribution Companies v. Federal Energy Regulatory Commission*, 88 F.3d 1105 (D.C. Cir. 1996) ("*UDC*") and *Georgia Public Service Commission*, 107 FERC ¶61,024, Docket No. RP04-92-000, Order on Petition for Declaratory Order, issued April 15, 2004. The Company further argued that the FERC's regulations governing capacity release transactions preempted the Commission from imposing the asymmetrical pricing rules as advocated by Staff and the Public Advocate. According to the Company, this Commission lacked jurisdiction to regulate access to capacity on interstate pipelines; rather, such transactions are governed solely by the FERC's capacity release rules, and under those rules the releasing shipper may only release capacity on terms that are not unduly discriminatory, anti-competitive, or otherwise unjust and unreasonable under the Natural Gas Act and the relevant pipeline’s FERC-approved tariff provisions. (*Id*. at 15-16).

24. According to the Company, the FERC’s capacity release rules recognize that shippers at times will have more capacity than they need. Rather than require these shippers to absorb 100% of the costs associated with this capacity, the FERC enacted rules to provide a uniform, transparent and nondiscriminatory market for capacity that is temporarily not needed by a shipper. Without this market, the unused capacity would stand idle, to the detriment of natural gas consumers. The settlement in Docket 07-246F, coupled with the FERC capacity release rules, provide a mechanism for minimizing the potential for abuse. (CRB at 3).

25. The Company further contended that if the Commission were to order Chesapeake to comply with the asymmetrical pricing rules, Chesapeake could be exposed to potential sanctions, civil penalties and disgorgement orders by the FERC. (COB at 16).

26. The Company argued that Staff’s and the DPA’s proposal would have a “chilling effect” on Chesapeake’s capacity releases and was nothing more than an attempt to circumvent the FERC capacity release rules. (CRB at 6). It argued that the imputation of phantom revenues would, as a practical matter, remove its incentive to enter into prearranged capacity release transactions because if PESCO bid more than PESCO’s competitor was willing to pay, FERC rules would require the Company to release the capacity to PESCO at the price that

PESCO bid, but the Company would have to credit the difference between the maximum rate and the price actually paid by PESCO to the GSR. Thus, the imputation rule would punish the Company by requiring it to assume that PESCO paid the maximum rate. If PESCO did not submit a bid in an effort to avoid this "penalty" to the Company, then the capacity would not be released to the entity that values it the most, contrary to the goal of FERC. (*Id*. at 7-8).

27. The Company argued that Staff's reliance on *Kentucky West Virginia Gas Company v. Pennsylvania Public Utility Commission*, 837 F.2d 600, 609 (3d Cir. 1988) was misplaced because that case involved a state commission's challenge to the prudence of a utility's decision to purchase energy from its affiliate, as opposed to a cheaper alternative. The initial $.17 per Dth rate was posted for bidding, as required by the FERC, and there is no evidence in this case suggesting that Chesapeake sold the capacity to PESCO for less than market value or that it had rejected a more attractive offer in favor of PESCO. (*Id.* at 8). The Company similarly rejected Staff's attempt to distinguish this case from the FERC's decision in *Georgia Public Service Commission*, contending that the FERC in that case made it clear that, while a state commission can mandate how much interstate pipeline capacity a regulated utility can hold, a state commission's attempt to regulate access to and use of such interstate capacity intrudes on the FERC's exclusive jurisdiction over such matters, and the imputation rule advocated in this docket by Staff and the DPA is nothing more than an indirect attempt to regulate access to and use of interstate capacity by PESCO. In the Company's view, Staff's and the

Public Advocate’s imputation rule would result in a separate set of rules for capacity released to PESCO and would remove capacity from the market. (*Id*. at 9).

28. Finally, the Company contended that, even if this Commission was not preempted from exercising jurisdiction over the Company’s transactions with PESCO, those transactions did not come within the scope of the Settlement in Docket 00-523 because, in making the capacity releases, Chesapeake was neither providing a service to PESCO nor transferring assets to PESCO. (COB at 18-19). First, the Company contended that the short-term capacity being released to PESCO was different than the long-term firm capacity Chesapeake purchases from ESNG to serve firm customers because the capacity released to PESCO is recallable and is for a shorter period of time. (COB at 18). Next, the Company argued that PESCO does not pay the Company for the capacity releases, but rather makes the payment to ESNG, and ESNG provides the capacity to PESCO. (CRB at 9-10). Based on these facts, the Company argued that the Company was not providing a service to PESCO, nor was it transferring an asset. Furthermore, the Company dismissed Staff’s contention that the Company waived its right to rely on the FERC’s capacity release rules, contending that: (1) compliance with the FERC’s capacity release rules cannot be waived; (2) the FERC’s capacity release rules were not enacted for the sole benefit of marketers such as PESCO; (3) allowing a shipper or marketer to “waive” all or a part of the FERC’s capacity rules would create chaos in the capacity release market; and (4) the Company did not have a marketing affiliate when the order in Docket No. 00-523 was entered, so issues

associated with releasing capacity to a marketer never came up in Docket 00-523. (*Id*. at 10).

B. <u>Staff</u>

29. Staff contended that the asymmetric pricing principles approved in Docket No. 00-523 require Chesapeake to transfer the released capacity to its affiliate PESCO at the higher of either (1) fully-allocated cost or (2) market price, and that the Commission should require the Company to apply such principles to capacity releases to PESCO going forward. (Staff Answering Brief at 2, 23 (hereafter "SAB at __").

30. First, Staff disagreed that the Docket 07-246F settlement agreement precluded application of the asymmetrical pricing provisions in Docket No. 00-523. (SAB at 9-12). Staff contended that little or no information had been available to the parties in Docket No. 07-246F regarding the extent of the Company's capacity releases and the level of sales being made to PESCO, so the matter could not have been "specifically addressed" in that docket, and that it was only the discovery in this case that revealed the extent of those releases and sales. (*Id*. at 12). Moreover, Staff argued that simply because a party took one position in one case did not mean the party was forever wedded to that position, pointing to the provision of the Docket No. 07-246F settlement that permitted parties to take contrary positions in future cases. (*Id.*).

31. Next, Staff disagreed that the FERC's exercise of authority over capacity release transactions preempted this Commission from applying the asymmetric pricing rule approved in Docket No. 00-523.

(*Id*. at 13-18). Staff acknowledged that the FERC had asserted jurisdiction over capacity releases, and that the District of Columbia Court of Appeals had upheld one such assertion of that jurisdiction in *UDC*; however, Staff contended that *UDC* did not address the issue presented here. Furthermore, Staff argued that under the Natural Gas Act, 15 U.S.C. §§717 *et seq.*, states have the authority to regulate the rates that a local distribution company such as Chesapeake charges its retail customers. (*Id.* at 13-14), citing *Kentucky West Virginia Gas Company v. Pennsylvania Public Utility Commission*, 837 F.2d 600, 609 (3d Cir. 1988). Staff contended that the Commission would not be questioning the rate that FERC has set for capacity releases or forbidding Chesapeake from releasing capacity to its affiliate; rather, it would only be requiring Chesapeake to credit Delaware retail customers' rates for the full amount of the FERC-approved maximum rate when Chesapeake made such releases to its affiliate. (*Id*. at 14). Staff then explained that the Company's reliance on the *Georgia Public Service Commission* FERC decision was misplaced because even FERC had acknowledged that there is room for states to exercise their authority in situations involving pipeline capacity releases. (*Id.* at 14-16).

32. Staff rejected the Company's contention that requiring PESCO to pay the maximum FERC-approved rates would be unduly discriminatory, in violation of FERC regulations, arguing that the Company could continue to charge PESCO 17 cents per Dth for the capacity (or whatever rate it determines), and PESCO could then sell

that capacity to the OSS customers for whatever price it could get; therefore, PESCO would not be disadvantaged. (*Id.* at 16-17).

33. Finally in this regard, Staff dismissed the Company's contention that it would be subject to potential sanctions by the FERC if it applied asymmetric pricing to its capacity release transactions with PESCO, pointing out that all of the authority on which the Company had relied involved substantial ongoing violations of FERC's "flipping," "shipper must have title," and buy-sell regulations, and that the Company had not provided any authority showing that the FERC had ever assessed penalties, sanctions or ordered disgorgement against a shipper complying with a state commission directive that ultimately was found to be within the FERC's sole purview. (*Id*. at 17-18).

34. Last, Staff contended that the release of pipeline capacity was indeed a "transfer of assets" or the "provision of a service" subject to the asymmetric pricing principles set forth in the settlement of Docket No. 00-523, questioning what PESCO was paying for if not an asset or service. (*Id*. at 18-21). It further noted that the FERC regulations regarding capacity releases were in existence at the time the Company agreed to the settlement of Docket No. 00-523, and so it waived any right it may have had to rely upon FERC regulations with respect to its transactions with its affiliate because it entered into that settlement with full knowledge of the existence of the FERC regulations. (*Id*. at 21-22).

C. <u>Public Advocate</u>

35. The Public Advocate also contended that asymmetric pricing principles should apply to the capacity release transactions between

Chesapeake and its affiliate PESCO. (Public Advocate Answering Brief at 5 (hereafter "PAAB at __")). The Public Advocate argued that asymmetric pricing principles are intended to ensure that regulated utilities do not "gouge" the ratepayers as a result of unregulated self-dealing, (*Id*. at 6). Thus, it is immaterial whether another entity such as the FERC exercises authority over the manner in which the capacity release is effected; according to the Public Advocate, if a Commission-regulated utility enters into a self-dealing transaction, this Commission has the authority to determine the effect of that transaction on the rates the utility can charge its Delaware ratepayers. (*Id.* at 6-7).

36. Next, the Public Advocate dismissed as "meritless" Chesapeake's assertion that applying asymmetrical pricing principles to its capacity release transactions with PESCO would unfairly discriminate against PESCO, noting that Chesapeake was under no legal obligation to release any capacity to PESCO and PESCO had no right to demand that Chesapeake release capacity to it. (*Id* at 6.). The Public Advocate contended that there was no evidence that there were any other bidders that might compete against PESCO in any FERC-mandated auction. (*Id*. at 7). Furthermore, the Public Advocate argued that Chesapeake's designed 17 cent-per-Dth rate was contrary to a true auction process and was calculated without considering the underlying cost of the capacity.

37. Like Staff, the Public Advocate rejected the Company's contention that the capacity release transactions involved neither a service nor a transfer of assets, arguing that the Company's assertion

that the release is to ESNG rather than to PESCO directly ignored the fact that Chesapeake released the capacity to ESNG so that ESNG could then provide that capacity to PESCO. (*Id*. at 8). Additionally, the Public Advocate pointed out that intangible contractual rights can be assets, and that when Chesapeake releases capacity it has less capacity and fewer rights, and PESCO has more capacity and additional rights. (*Id.).* Moreover, the fact that Chesapeake received 17 cents per Dth for this capacity indicates that the capacity has value. (*Id*).

38. The Public Advocate also asserted that the settlement in Docket No. 07-246F did not preclude application of asymmetric pricing principles. (*Id*.*).* The Public Advocate observed that the rates approved in Docket No. 07-246F were open for review as a result of the Company’s application in this docket for approval of GSR rates. Furthermore, the Commission and the Public Advocate were empowered to examine Chesapeake’s GSR rates at any time. (*Id.*).

39. Finally, the Public Advocate contended that this was not a docket to determine how much or in what manner Chesapeake ought to release capacity, how ESNG ought to remarket that capacity or how much PESCO ought to pay for it. Rather, he argued, this is a proceeding to establish just and reasonable rates to be charged to Delaware ratepayers, and the only issue was how much credit ratepayers ought to receive for the sale of capacity for which they paid full price. (*Id*. at 9).

THE HEARING EXAMINER'S FINDINGS AND RECOMMENDATIONS

40. On January 7, 2010, the Hearing Examiner issued his report containing his proposed findings and recommendations (hereafter "HER at __").

41. The Hearing Examiner first concluded that "Chesapeake's practice of charging more than three (3) times the cost of gas to Delaware ratepayers than that charged to its affiliate PESCO for sale to PESCO's off-system customers, has violated Paragraph II(10)" of the settlement in Docket No. 00-523. (HER at 29-30). He found that a transfer of assets had occurred, or, alternatively, a service was involved, and therefore the Company was required to apply asymmetrical pricing principles even if the capacity released to PESCO was "recallable" on a design day or otherwise. (*Id.* at 30). The Hearing Examiner was persuaded by Public Advocate witness Andrea Crane's testimony. Ms. Crane testified that the asymmetric pricing principles were designed to cover both transfers of balance sheet items (assets) as well as transfers affecting the income statement (services), and that if Chesapeake was not selling either an asset or a service, she questioned for what was it being paid? Ms. Crane concluded that there was "obviously some item of value being transferred", and since utilities generally expense capacity costs, she considered the provision of capacity to also be a service in this case. Furthermore, although Chesapeake was not directly providing the service to PESCO, it was providing the right to receive that service from ESNG; therefore, PESCO was receiving a service from Chesapeake, regardless of whether it was characterized as transportation service or the right

to receive transportation service from ESNG. Finally, she testified that it was immaterial that the capacity was being provided pursuant to ESNG's tariff provisions because ESNG's tariff did not address the pricing of affiliated transactions to Delaware retail customers, which is within this Commission's purview. (HER at 30-31, quoting Exh. 22 (Crane) at 12-13).

42. The Hearing Examiner next concluded that "Chesapeake's practice of charging its Delaware ratepayers more than three (3) times the cost of gas than paid by its affiliate PESCO for sale to PESCO's off-line customers" also violated Paragraphs B(3) and B(4) of the Code of Conduct, which prohibit Chesapeake from providing a price preference to PESCO's non-regulated customers over Chesapeake's regulated ratepayers.[7] (HER at 31-32). Consequently, he was persuaded that "Staff and the DPA are correct in recommending that the Commission order that Chesapeake credit the GSR (i.e., Delaware ratepayers) the difference between the amount Chesapeake paid its affiliate Eastern Shore Natural Gas and the amount paid by the Company's affiliate PESCO, beginning in January 2008 through the present … ." (*Id*. at 32).[8]

43. Third, the Hearing Examiner found that Chesapeake's practice violated 26 *Del. C.* §303(a)'s injunction against unjust or unreasonable, unduly preferential or unjustly discriminatory rates because "charging Delaware's regulated ratepayers three (3) times the

[7] The Commission notes that no party argued that Chesapeake had violated the Code of Conduct.

[8] As noted previously, Staff actually only recommended application of the asymmetrical pricing provisions going forward. (SAB at 2, 23).

amount paid by PESCO is an 'unjust, unreasonable … [and] unduly preferential' rate and gives an 'undue and unreasonable preference' to PESCO's customers over Delaware ratepayers." (*Id*. at 33-34). Furthermore, the Hearing Examiner found that Chesapeake had not satisfied its burden of proving that the proposed rate was just and reasonable as required by 26 *Del. C.* §307(a). (*Id*. at 34).[9]

44. Fourth, the Hearing Examiner rejected the Company's contention that the settlement agreement in Docket No. 07-246F overrode the asymmetrical pricing provisions of the Docket No. 00-523 settlement. The Hearing Examiner observed that the Docket No. 07-246F settlement permitted Staff and the Public Advocate to request the Commission to "disallow Chesapeake's practice" now that they had become aware of Chesapeake's practices involving PESCO. (*id*. at 34-35). The Hearing Examiner accepted Staff's contention that there was little information available to the parties in Docket No. 07-246F regarding the extent of the Company's capacity releases to PESCO and no information regarding the level of sales being made to PESCO, so the matter could not have been '"specifically addressed" in that docket, and that it was not until discovery in this case revealed the extent of those releases and sales that Staff and the Public Advocate became concerned that Chesapeake's Delaware customers were subsidizing PESCO. (*Id*. at 35, quoting SAB at 12). The Hearing Examiner observed that Chesapeake had not cited to any record evidence from Docket No. 07-246F to support its contention that it had informed the parties

[9] The Commission notes that no party argued that Chesapeake had violated 26 *Del. C.* §§303(a) or 307.

that the historical five-year average of OSS margins credited to the GSR had totaled approximately $160,000 and that Chesapeake would therefore release capacity to PESCO at a rate equating to a credit for capacity release revenue approximating that five-year historical average. (*Id*. at 35-36, quoting COB at 2). Nor had the Company provided any explanation from the record evidence in Docket No. 07-246F regarding the parties' intent in entering into that settlement or that Chesapeake had informed the parties to Docket No. 07-246F that it intended to release capacity to its subsidiary at less than one-third of the cost charged to Delaware ratepayers. (*Id*. at 36).

45. The Hearing Examiner next addressed whether this Commission had jurisdiction to address this issue. He cited the statutory provisions describing the Commission's general jurisdiction to supervise and regulate public utilities and their rates and to set just and reasonable rates for those utilities. (*Id*. at 37). He acknowledged that the parties had agreed that the FERC has asserted jurisdiction over capacity releases, but noted that that jurisdiction was not without limits: the states have the sole authority to regulate the rates that a local distribution company such as Chesapeake charges its retail customers. (*Id*. at 37-38, citing 15 U.S.C. §717(b) and *Kentucky West Virginia Gas Company*, *supra.*) The Hearing Examiner concluded that the Commission had jurisdiction in this matter because: (1) Section 717(b) of the Natural Gas Act excludes retail sales from FERC's jurisdiction; and (2) *Kentucky West Virginia Gas Company* held that the state commission was permitted to determine the justness and

reasonableness of gas purchases from its subsidiary in exercising authority over intrastate utility rates. (*Id*. at 39).

46. The Hearing Examiner agreed with Staff and the Public Advocate that the Commission would not be interfering with the rate that the FERC has or will set for capacity releases, nor the access to or manner in which Chesapeake acquired the capacity. (*Id.* at 40). He agreed with Staff and the Public Advocate that Chesapeake could continue to release capacity to PESCO at 17 cents per Dth or at any other rate. (*Id*.). Furthermore, the Hearing Examiner addressed at length the *Georgia Public Service Commission* FERC decision upon which Chesapeake relied, noting that in that case the FERC had acknowledged that states may assert jurisdiction over how much interstate pipeline capacity a utility should hold, including whether a utility should acquire or relinquish capacity. (*Id*. at 40-42, quoting from *Georgia Public Service Commission*, *supra,* at 49). The Hearing Examiner found that Staff and the Public Advocate were not asking the Commission to regulate Chesapeake's access to capacity, to restrict Chesapeake's ability to release capacity to PESCO, to restrict PESCO's ability to purchase Chesapeake's released capacity, or to set rates for those capacity releases. (*Id*. at 43). He observed that the Company could continue to charge PESCO 17 cents per Dth (or whatever other price it could obtain from PESCO), but because this was an affiliated transaction and the rate at which Chesapeake releases capacity to PESCO affects the rate Delaware ratepayers pay for their natural gas service, the Commission may require Chesapeake to apply asymmetrical pricing principles. (*Id*.). He concluded that this would not restrict

access to interstate capacity and therefore was not preempted by the FERC because it was not applied in such a way as to interfere with the federal regulatory scheme. (*Id*.).

47. The Hearing Examiner rejected Chesapeake's argument that applying asymmetric pricing to its capacity releases to PESCO would unduly discriminate against PESCO, noting that the Company could continue to release capacity to PESCO at 17 cents per Dth or some other price – but if it did, Chesapeake would be required to credit the GSR with the difference between the sale price and the applicable maximum rate. (*Id*. at 44).

48. Finally, the Hearing Examiner rejected Chesapeake's contention that the FERC's regulatory authority over capacity release transactions preempts the Commission from requiring that asymmetrical pricing be used in the release of any capacity to PESCO. He acknowledged that the FERC does exercise jurisdiction over capacity release transactions and that FERC Order No. 636 created a 'comprehensive capacity release program to increase the availability of unbundled firm transportation capacity by permitting firm shippers to release their capacity to others when they are not using it, and that the FERC further developed those rules in Order Nos. 637 and 712. (*id*. at 45-46). However, he stopped short of finding that the Commission was preempted from determining the retail rate to be charged to Delaware ratepayers "because of one court's holding that imposition of the 'highest bidder' aspect of FERC's capacity release rules pre-empted a California 'buy-sell' program that allowed end-users to contract with a local distribution company (LDC) without

participating in the open bidding process." (*Id*. at 46). The Hearing Examiner recognized that the FERC does not permit unduly discriminatory or anti-competitive restrictions on access to released capacity, but did not find that to be the case here. (Id. at 48). The Hearing Examiner sided with Staff and the Public Advocate's argument that unlike the buy-sell agreements at issue in *UDC*, the Commission's adoption of the imputation rule he recommended would not conflict with the FERC's rules for capacity releases, or the access to or manner in which Chesapeake acquires or releases capacity. (*Id*. at 47-48).

49. The Hearing Examiner was unconvinced of the potential penalties that the FERC might impose upon Chesapeake in the event that the Commission requires it to apply asymmetric pricing. The Hearing Examiner noted that in each of the cases Chesapeake cited in support of this potential, the company penalized by FERC had engaged in substantial, prolonged violations of various FERC regulations. (*Id*. at 49-50), He observed that the Company had not provided any authority showing that FERC had assessed such penalties against a shipper that was adhering to a state commission's directive on a matter that was later found to be within the FERC's sole jurisdiction. (*Id*. at 50-51). He further noted that the Company could request the Commission to stay implementation of any order requiring application of asymmetrical pricing to allow the Company the opportunity to appeal or to obtain a declaratory order from FERC. (*Id*. at 51).

50. In summary, the Hearing Examiner recommended that the Commission: (a) find that Chesapeake's practice violates the

Commission’s order in Docket No. 00-523 and also violates 26 *Del. C.* §303(a); (b) the Commission should not follow the settlement approved in Docket No. 07-246F because it does not support the order approving the Docket No. 00-523 settlement or Section 303(a); (c) Chesapeake should be required to credit the GSR with the difference between the applicable maximum rate and the rate at which Chesapeake released capacity to PESCO from January 2008 to the present, plus interest; (d) if the Commission requires application of asymmetric pricing principles and orders Chesapeake to credit the GSR back to January 2008, it should stay implementation of its order pending appeal or application to the FERC for a declaratory order; and (e) order Chesapeake to adhere strictly to asymmetric pricing principles regarding all future off-system sales by PESCO. (*Id*. at 51-52).

CHESAPEAKE’S EXCEPTIONS

51. Chesapeake excepted to the Hearing Examiner’s proposed findings and recommendations. Chesapeake contended that the Hearing Examiner’s recommendations were based on “the mistaken assumption that Chesapeake’s capacity purchases are driven in part by the amount of capacity needed to serve OSS customers.” (Chesapeake Brief on exceptions at 2) (hereafter “CBOE at __”). Chesapeake argued that its capacity purchases are driven by what it deems necessary to serve its Delaware firm customers on a design day. (*Id*.).

52. Chesapeake also argued that the Hearing Examiner erred in assuming that Chesapeake charges its Delaware Division firm customers 0.5915 per Dth for capacity, when in fact the rate those customers pay is based on whether they are in Zone 1 (0.2968 per Dth) or Zone 2

(0.5699 per Dth). Therefore, the Hearing Examiner's conclusion that Chesapeake received $388,223 from PESCO for the releases while paying ESNG $1,305,788 was wrong. (*Id*.).

53. Next, Chesapeake contended that it complied with the terms of the Docket No. 07-246F settlement agreement. (*Id*. at 3). It contended that the settlement agreement in Docket No. 00-523 requiring asymmetric pricing could not supersede the settlement in Docket No. 07-246F because it was approved almost eight years before the Docket No. 07-246F settlement, and as a general rule a new settlement will supersede a prior settlement to the extent the new settlement is inconsistent with the terms and conditions of the prior settlement. (*Id*., citing *Country Life Homes, Inc. v. Shaffer*, 2007 WL 33075 (Del. Ch. Jan. 31, 2007)). The Company acknowledged that, when the Commission approves a settlement, it retains jurisdiction to review the terms and conditions of such settlement prospectively; here, however, the Hearing Examiner was recommending that the Commission order Chesapeake to retroactively credit the GSR for the difference between the credit that it received from ESNG for capacity released to PESCO and the amount Chesapeake would have received had it released the capacity at the higher of cost or market. (*Id*.). The Company argued that in releasing capacity to PESCO, it reasonably relied on the terms and conditions of the Docket No. 07-246F settlement, and it could not now undo those transactions. (*Id*.).

54. The Company argued that neither Staff nor the Public Advocate had contended that Chesapeake violated the terms of the Docket No. 07-246F settlement. (*Id*. at 3-4). It asserted that the

Hearing Examiner had relied on Staff's "unsupported statement" that there had been little to no information available regarding the Company's capacity releases and level of sales to PESCO. (*Id*. at 4). However, the Company contended, it did not begin releasing capacity to PESCO to serve the former OSS customers until January 2008; the parties to the Docket No. 07-246F settlement knew that the Company would have to release capacity to PESCO to serve the former OSS customers; and the Docket No. 07-246F settlement was "specifically designed to deal with the economic ramifications of the transfer of the OSS customers to PESCO and the release of capacity to PESCO to serve those customers." (*Id.* at 4-5). In any event, the Company contended that the alleged lack of information provided no basis for rewriting the settlement retroactively. (*Id.*). The Company disagreed that the selection of the 0.17 per Dth rate for PESCO was arbitrary, asserting that Chesapeake had presented "undisputed" testimony that the rate was designed to equate to "a credit for capacity release revenue approximating the 5-year average annual margin share under the discontinued OSS program," and that rate was set in accordance with the Docket No. 07-246F settlement. (*Id.* at 4). The Company noted that it had presented the undisputed testimony of Jennifer Clausius that in Docket 07-246F, the Company informed the parties that the historical five-year average of OSS margins credited to the firm customers totaled approximately $160,000 per year (Ex. 21, at 8) and that the Company would release capacity at a rate that would equate to a credit for capacity release revenue approximating the 5-year average annual margin share under the discontinued OSS program This testimony was included in the direct testimony of the Company, and neither Staff nor DPA filed any testimony to the contrary. If the parties had intended to apply asymmetric pricing, the Company concluded, there would have been no need to design such a credit. (*Id*. at 4-5).

55. Next, the Company contended that the Hearing Examiner's reliance on Paragraphs 12 and 15 of the Docket No. 07--246F settlement agreement as support for his recommended retroactive credit to the GSR was misplaced because those provisions only give the parties the right to take a contrary position in future cases, not to retroactively rewrite the terms of a prior settlement. (*Id*. at 5-6).

56. The Company further argued that the Docket No. 07-246F settlement agreement was effectively a contract, and that it was unlawful to rewrite it; consequently, if the Commission should find that asymmetrical pricing should apply, that decision should be prospective only. (*Id*. at 6).

57. The Company disputed the Hearing Examiner's conclusions that it had violated either the settlement agreement in Docket No. 00-523 or 26 *Del. C.* §303(a). (*Id*. at 7). It observed that complying with both the settlement agreements in Docket Nos. 00-523 and 07-246F would be "impossible." Furthermore, it contended that the Hearing Examiner erred in concluding that the Company's practice resulted in unjust or unreasonable rates because a practice approved by the Commission cannot, as a matter or law, be deemed unjust or unreasonable, nor could the release of capacity in accordance with FERC rules result in an unjust or unreasonable rate. (*Id*.). In this

regard, the Company contended that the Hearing Examiner misunderstood the difference between long-term firm capacity rights and recallable short-term capacity rights, and failed to recognize that the rates charged to Delaware ratepayers for the long-term capacity on ESNG are FERC-approved rates that the Commission is required to allow the Company to recover in retail rates. (*Id*.).

58. The Company next contended that the Commission should reject the Hearing Examiner's recommendation to apply asymmetrical pricing to its capacity releases to PESCO. (*Id.*). First, it argued that the recommendation would be detrimental to Delaware ratepayers because it would, as a practical matter, eliminate capacity releases to PESCO. (*Id.* at 8). Again, the Company asserted that the Hearing Examiner's recommendation was based on his mistaken belief that the Company purchases capacity to serve OSS customers. However, the Company stated, it must purchase sufficient capacity to serve its firm customers on a design day, which requires it to forecast its growth for the next several years and determine the amount of capacity needed; then it must enter into agreements with transmission pipeline companies; and FERC must approve construction of transmission facilities. When design-day conditions do not exist, the Company attempts to recover some of the cost of the capacity by releasing it to other parties on a short-term basis. (*Id*.). Thus, the Company concludes, "it is misleading to compare the price that the Company pays for long-term capacity … to the short-term capacity release rate for capacity that is released to marketers on a recallable basis. The focus should be on the value of the short-term capacity at a point in

time when and if the Company does not have a present need for that capacity." (*Id*. at 8-9).

59. The Company further argued that the Hearing Examiner erred in concluding that in releasing capacity to PESCO on a short-term basis at less than what the Company pays for long-term capacity, it gave an unlawful price preference to PESCO. It observed that neither it nor PESCO is under any legal obligation to serve the OSS customers, and those customers have no right to demand service from either the Company or PESCO. Moreover, the OSS customers can purchase natural gas from any party or use alternative fuels. The Company can charge interruptible transportation customers a lower rate than firm customers because the Company can terminate deliveries on relatively short notice and those customers can use an alternative fuel. Additionally, the capacity available for release at any given time is posted on an electronic bulletin board, and any party has the right to submit a bid for that capacity. Thus, that lower rate is not an unjust price preference, and, the Company predicts, the Hearing Examiner's recommendation "will create havoc in the capacity release market" if adopted. (*Id*. at 9).

60. The Company argues that the potential for abuse is eliminated because it must comply with FERC capacity release rules, which are "transparent." (*Id*. at 10). Requiring the Company to apply asymmetric pricing would harm Delaware Division customers because the Company would have no economic incentive to release capacity to PESCO and PESCO would have no economic incentive to pay a long-term price for short-term capacity. PESCO could purchase capacity from some

other shipper, leaving Delaware customers with no credit to the GSR. Therefore, the Company concluded, the Commission should reject the Hearing Examiner's recommendation. (*Id*.).

61. Finally, the Company contended that asymmetric pricing principles do not apply to capacity release transactions because the capacity releases are neither the provision of a service nor transfer of any balance sheet asset. (*Id*. at 10-11). The Company asserts that ESNG provides the transmission service directly to PESCO and once that occurs, Chesapeake has no rights to the capacity unless it is recalled. Furthermore, it argues that PESCO pays ESNG for the capacity and ESNG credits Chesapeake's invoice because the Company has elected not to use that capacity. Thus, the Hearing examiner's references to the sale of "gas" is erroneous. (*Id*. at 11).\

62. In any event, the Company contends that asymmetrical pricing should not apply to transactions conducted pursuant to FERC capacity release rules, which address the pricing of capacity releases and how that price is to be determined. Those rules provide for transparency and open bidding. The Company argues that if the purpose of asymmetrical pricing is to ensure that ratepayers do not subsidize unregulated activities, this purpose is achieved by the FERC capacity release rules and the Docket No. 07-246F settlement. (*Id*. at 11).

63. The Company stated that all parties had recognized that FERC has asserted jurisdiction over capacity release transactions, and cited again to the *UDC* and *Georgia Public Service Commission* cases as support for its contention that FERC has exclusive jurisdiction over capacity release transactions. (*Id*. at 12-13). The Company argued

that the imputation rule advocated by Staff and DPA and adopted by the Hearing Examiner, is a classic example of trying to do indirectly what cannot be done directly. The Company asserted that the logic of the imputation rule boils down to the proposition that Chesapeake can charge PESCO whatever it wishes for short-term capacity releases, and the Commission can avoid conflict with FERC's rules, by claiming that the imputation rule is only an exercise of its jurisdiction over retail sales rates. The Company urged the Commission to reject such logic, as the court in *UDC* did when it held that FERC's capacity release rules pre-empted a state-approved "buy-sell" program in which end-users and distributors used a retail gas sales strategy in an attempt to skirt, by indirection, the FERC's capacity release rules (see also COB, at pp. 10-13). The Company dismissed the Hearing Examiner's discussion of those cases, contending that the Hearing Examiner missed the "fundamental point" that "a state-approved program or action that conflicts with FERC's capacity release rules indirectly is pre-empted by those rules just as much as a state action that is aimed directly at those rules." (*Id*. at 13). The Company argued that adoption of the Hearing Examiner's recommendation would penalize the Company if it released capacity to PESCO at a market-based rate that was less than the maximum rate paid for long-term capacity, and would have a "chilling effect" on any further capacity releases to PESCO. (*Id*. at 13-14). In conclusion, the Company claimed that the Hearing Examiner's recommendation was anticompetitive, discriminatory and would interfere with FERC's competitive bidding process. (*Id*. at 14).

THE FEBRUARY 18, 2010 COMMISSION MEETING

64. At our February 18, 2010 meeting, we heard oral argument from the parties. The Company reiterated the arguments it had proffered in its exceptions. The Public Advocate supported the Hearing Examiner’s proposed recommendation. Staff supported the Hearing Examiner’s recommendation that the Commission require the Company to apply asymmetrical pricing to its capacity release transactions with PESCO, but took the position that the recommendation should not be applied retroactively. Staff also suggested to the Commission that it did not need to address the Hearing Examiner’s recommendations regarding Paragraphs B(3) and B(4) of the Code of Conduct and Section 303(a) of the Delaware Code, as no party had raised those issues and the Commission could reach the same conclusion without addressing those matters.

65. We were troubled by the issues raised in this proceeding. On the one hand, we were concerned about the transactions between Chesapeake and its unregulated affiliate and the appearance that ratepayers were subsidizing that unregulated affiliate. We questioned whether the 17 cent-per-Dth price was truly a market rate, or, indeed, whether there was a real market for the capacity. We struggled with the issue of whether the settlement agreements in Docket Nos. 00-523 and 07-246F, both of which we approved, could be harmonized. At the conclusion of our deliberations, it was clear to us that we were unable to reach a decision based on the record information and arguments presented to us. Thus, we tabled our deliberations until the March 16, 2010 meeting to allow the parties to make additional

submissions addressing the questions that we had raised during our deliberations.

THE PARTIES’ SUPPLEMENTAL SUBMISSIONS

66. On March 4, 2010, each of the parties filed supplemental submissions.

67. **Chesapeake.** The Company again contended that the Hearing Examiner’s recommendation of a retroactive refund should be rejected because the Docket No. 07-246F settlement superseded the Docket No. 00-523 settlement, offering the following equitable reasons for rejecting that recommendation: (1) the ratepayers benefited from the release of capacity; (2) the Company acted in good faith when it released capacity to PESCO at the designed rate; (3) changing the terms of the Docket No. 07-246F settlement retroactively would discourage settlements; (4) it would be unfair to punish the Company for doing what it told Staff and the Public Advocate it would do without having received any objection from Staff or the Public Advocate at that time; (5) requiring a retroactive refund assumed that PESCO would have purchased the same amount of capacity had the Company charged it an above-market rate; (6) neither Staff nor the Public Advocate had contended that the Company did not comply with the Docket No. 07-246F settlement; (7) the capacity release revenues credited to the GSR were better than what any party anticipated; and (8) in releasing capacity to PESCO, Chesapeake complied with federal capacity release rules. (Chesapeake Supplemental Submission at 1-2) (hereafter “CSS at __”).

68. Next, the Company argued that no federal or state law required asymmetrical pricing, and it would not be good policy to do so because: (1) other utilities had released short-term capacity at $.08 per Dth; (2) forcing Chesapeake to charge PESCO an above-market rate will eliminate capacity releases to PESCO without a reduction in the Company's long-term capacity costs; (3) the Company has released capacity to other non-affiliated parties who compete with PESCO and who would not be subject to asymmetrical pricing principles; (4) it would create confusion because it would be difficult to determine what was "the higher of cost or market" for short-term capacity; and (5) FERC's capacity release rules and the Docket No. 07-246F settlement provide adequate safeguards. (*Id*. at 2).

69. The Company focused on the mistaken "assumption that [its] 'cost' of the short-term capacity released to PESCO is equal to the 'cost' of the long term capacity ('max rate') purchased by the Company," because 'it goes to the very core of the Company's argument that asymmetrical pricing makes no sense in the context of short-term capacity releases." (*Id*.). Once again, the Company repeated its argument that it must contract for long-term capacity sometimes years in advance of when it is needed to serve its customers, and that this capacity is firm, which means that the transmission pipeline is required to allow Chesapeake to use the capacity at any time. In contrast, the capacity released to PESCO is short-term; no long-term planning is required and no additional facilities need to be built. Furthermore, the capacity released to PESCO is recallable. Therefore, the Company argued, the capacity released by Chesapeake to PESCO does

not have the same contract rights as the capacity that Chesapeake obtains to serve its firm customers, and the cost is not the full cost of Zone 1 or Zone 2 capacity but rather some other amount. (*Id*. at 2-3).

70. The Company reiterated that its release of interstate pipeline capacity is an interstate transaction, and its right to release such capacity is based on a limited certificate of public convenience granted by the FERC. The Company pointed out that, in the *UDC* case, state public utility commissions and local distribution companies (LDCs) argued that the FERC lacked jurisdiction over capacity releases by LDCs to their end-users. The Court rejected this challenge, and held that the FERC's jurisdiction over the interstate transportation of natural gas was exclusive. The Company again reiterated its contention that *UDC* made it clear that local distribution companies may not engage in capacity releases without regard to the principles of open access and nondiscrimination, and that asymmetrical pricing will discriminate against PESCO and eliminate a potential bidder for the Company's short term capacity. Moreover, it again contended that if asymmetrical pricing is required, it will be penalized for complying with FERC's capacity release rules. (*Id*. at 3-4).

71. Finally, the Company argued again that it would not have been necessary for the Company to design a credit if not for the transfer of the OSS customers to PESCO, and if the Company had been required to charge PESCO the maximum rates there would have been no capacity releases to PESCO. (*Id*. at 4-5).

72. **Public Advocate.** The Public Advocate contended that the Docket No. 00-523 settlement was not abrogated by the Docket No. 07-246F settlement because the latter settlement contained nothing regarding the rate at which PESCO would purchase capacity or the rate at which Delaware ratepayers would be credited for those sales. (Public Advocate Supplemental Submission at 1) (hereafter "PASS at __").

73. Next, the Public Advocate argued that if Chesapeake has been bound by asymmetric pricing for the entire period during which it has released capacity to PESCO, then ratepayers must be given full credit in this proceeding for the entire cost. It contended that the Hearing Examiner's recommendation was not retroactive ratemaking since asymmetrical pricing has been required since these sales began and while these sales were taking place. (*Id*. at 1-2).

74. The Public Advocate further contended that FERC's capacity release rules do not preempt the Commission from exercising authority over Chesapeake's retail rates. He noted that the Company had no legal obligation to release capacity to PESCO and PESCO had no right to demand that the Company release capacity to it. Second, the Public Advocate observed that there was no evidence of any bidders that might compete against PESCO at any FERC-mandated auction; in essence, PESCO is the sole bidder. The Public Advocate found further evidence of the lack of any true auction process in the fact that the 17 cents-per-Dth capacity release rate had been designed by Chesapeake to return a certain margin to ratepayers. (*Id*. at 2).

75. Finally, the Public Advocate took issue with what it perceived as the Company's threat to cease releasing capacity at all if asymmetrical pricing is required and suggested that the Commission require Chesapeake to continue to make "continual, good faith efforts to sell excess capacity directly to its former OSS customers and to any other potential customer, and to make periodic reports to this Commission and the Public Advocate on its efforts to do so." (*Id*. at 2-3).

76. **Staff.** Staff addressed certain questions posed by the Commission at the February 18, 2010 meeting. First, Staff explained why the Hearing Examiner's recommendations with respect to 26 *Del. C.* §303(a), if adopted by the Commission, would violate the filed rate doctrine, and that the Commission need not adopt the Hearing Examiner's recommendations regarding either 26 *Del. C*. §303(a) or Paragraphs B(3) and B(4) of the Code of Conduct in order to conclude that asymmetrical pricing should be applied to the Company's capacity releases to PESCO. (Staff's Supplemental Submission at 1-3) (hereafter "SSS at __").

77. Second, Staff conceded that the asymmetrical pricing issue should have been raised in Docket No. 07-246F. Although Staff did not know why it had not been raised, it surmised (speaking only for Staff) that because the analyst, lawyer and consultant for Staff had been different than those in Docket No. 00-523, it simply did not occur to those participating in Docket No. 07-246F. (*Id*. at 4).

78. Staff responded to the suggestion that ratepayers had been overcharged during the period that asymmetrical pricing was not

applied by noting that the Commission had approved the rates in the Docket No. 07-246F settlement as just and reasonable. (*Id*. at 5).

79. Staff concluded that requiring the Company to credit the GSR with the difference between maximum rates and what Chesapeake received from PESCO from January 1, 2008 onward would constitute retroactive ratemaking, noting that it had not suggested that the credit be applied retroactively but only on a going-forward basis. (*Id*.).

80. Staff responded to the Commission’s question regarding the market price of capacity at the time Chesapeake sold that capacity to PESCO for 17 cents per Dth by noting that the information was not in the record, but that the Company was contending that 17 cents per Dth was the market price; therefore, the fully-allocated cost per zone, being higher, was the appropriate price to apply. (*Id.).*

81. Finally, Staff responded to the Commission’s question that Staff did not believe that the Company’s ability to recall capacity released to PESCO made that capacity worth less than what Chesapeake paid ESNG for capacity. Staff observed that the record indicated that Chesapeake had never recalled any of the capacity released to PESCO, and Staff believed that it was highly unlikely to do so outside the winter heating season. (*Id*. at 6).

DISCUSSION

82. We met again on March 30, 2010 to hear additional argument from the parties and revisit the issue we had tabled from February 16, 2010.

83. As is evident from the transcripts of the two meetings at which we heard from the parties and deliberated, this was a very difficult matter to resolve. There are compelling arguments on both sides. But having considered the entire record and the arguments of the parties, we find as follows.

84. First, we do not believe that FERC's exercise of jurisdiction over capacity release transactions precludes us from determining what effect those capacity transactions will have on Delaware retail rates. We are aware that the Court of Appeals for the District of Columbia considered the question of the extent of the FERC's jurisdiction over capacity release transactions in the *UDC* case cited by the Company and Staff, but it does not appear that the Court was presented with the situation here, which is how capacity release transactions between a regulated utility and its non-regulated marketing affiliate will be treated for retail ratemaking purposes. Indeed, the parties brought no authority to our attention in which this exact issue was addressed. And we recognize that the Court of Appeals for the Third Circuit has held that FERC has no jurisdiction over retail rates. *Kentucky West Virginia,* supra. Thus, we believe that we can address this matter without running afoul of the FERC's jurisdiction in the area of capacity release transactions.

85. Next, we find that asymmetrical pricing has been the rule of law since 2001 applicable to capacity release transactions between the Company and its non-regulated marketing affiliate, PESCO. There is nothing in Order No. 7450 approving the settlement in Docket No. 07-246F that suggests that that settlement abrogated the requirement

of asymmetrical pricing for affiliated transactions. We are not persuaded by the Company's contention that it is not providing a service or transferring an asset to PESCO. The fact of the matter is that even if the transfer is done at the ESNG level, the Company is benefitting from it in the form of a reduction in the amount that ESNG bills to it for purchased capacity. And the fact that ESNG actually effects the physical transfer of the capacity from Chesapeake to PESCO at ESNG's level does not change the fact that ESNG is simply a conduit for a transaction that at bottom is between Chesapeake and PESCO. Moreover, we find that the capacity that is released is an asset because it has value. If it were not valuable, PESCO would not pay Chesapeake even one cent for it.

86. Nor are we persuaded that the capacity Chesapeake purchases from ESNG at a FERC-approved rate is somehow transformed into some other capacity by virtue of it being released to PESCO on a short-term, recallable basis. As Staff pointed out, it is unlikely that such capacity will ever be recalled outside of the winter heating season, and it is undisputed on the record before us that the Company had not recalled any capacity that it had released to PESCO. (We are aware that Chesapeake stated in its supplemental submission that it *did* recall capacity this past heating season, but that is not part of the record in this docket).

87. The record does not contain sufficient information for us to determine whether there is truly a market for this capacity other than PESCO. But that is a very important consideration for us. The Company's contention that the 17-cent-per-Dth rate it charged PESCO

for the capacity is in fact a market rate would have greater force if we knew that PESCO was not the only potential purchaser for the capacity.

88. As for the question of whether requiring the Company to credit the GSR with the difference between maximum rate and what PESCO paid for the capacity going back to January 2008, for reasons set forth below, we disagree with the Company and Staff that to do so would constitute retroactive ratemaking. However, we will not order the Company to make such a credit in this proceeding. We do not believe that there is sufficient evidence on the record to establish that ratepayers were unfairly prejudiced. Furthermore, under the unusual circumstances of this case, we do not believe it would be equitable to require the Company to credit the GSR for that difference. We do wish to make perfectly clear that should the Company release any capacity to PESCO going forward at less than the maximum FERC-approved rate, we will require the Company to (1) continue to credit the GSR with the amount actually received from the capacity release; and (2) credit the GSR with the difference between that amount and the applicable maximum rate.

89. Finally, we believe that a new docket is needed to address whether asymmetrical pricing should continue to be required for capacity release transactions involving affiliates in light of the FERC rules governing such capacity releases. As part of that inquiry, we would expect the parties to address, among other things, the Company's existing capacity, the state of the capacity release market and the number of participants in that market, any differences between

the contract rights and cost with respect to the capacity purchased from ESNG to serve the Company['s firm customers and the contract rights and cost (if known) with respect to capacity released to PESCO, and any impact that asymmetrical pricing may have upon the Company's ratepayers and the ability of the Company to release capacity. (Unanimous).

ORDER

AND NOW. THIS 18th DAY OF MAY, 2010, BY THE UNANIMOUS VOTE OF ALL FIVE COMMISSIONERS, IT IS HEREBY ORDERED:

1. That the Commission is not preempted by the Federal Energy Regulatory Commission's jurisdiction over capacity release transactions from considering the issue of how capacity release transactions between a regulated utility and its non-regulated marketing affiliate will be treated for retail ratemaking purposes.
2. That the Hearing Examiner's Report be accepted, as modified below.
3. That from the date of this Order until such date as the Commission may otherwise order, the asymmetrical pricing principles approved in the settlement of Docket No. 00-523 shall be applied so that, should the Company release capacity to any affiliated company at less than the applicable FERC-approved maximum price for the applicable zone, not only will the amount the Company actually received from that transaction be credited to the GSR but also the difference between the maximum FERC-approved applicable zone rate and the amount

received by the Company from the transaction shall also be credited to the GSR.

4. That the Company shall not be required to credit the GSR with the difference between the maximum FERC-approved rate and the amount it received for capacity release transactions between it and its affiliate PESCO from January 1, 2008 to the present.
5. That the Company is instructed to file an application to open a new docket in which the Commission will consider whether it continues to be appropriate to apply the asymmetrical pricing principles established in Docket No. 00-523 to capacity release transactions between a regulated utility and a non-regulated affiliate in light of the FERC rules governing such transactions.
6. That the Commission reserves jurisdiction and authority to enter such further orders in this docket as may be deemed necessary or appropriate.

BY ORDER OF THE COMMISSION:

/s/ Arnetta McRae
Chair

/s/ Joann T. Conaway
Commissioner

/s/ Jaymes B. Lester
Commissioner

/s/ Dallas Winslow
Commissioner

/s/ Jeffrey J. Clark
Commissioner

ATTEST:

/s/ Alisa Carrow Bentley
Secretary