

STATE OF VERMONT
PUBLIC SERVICE BOARD

In Re Petition of Vermont Gas Systems, Inc.,)	
pursuant to 30 V.S.A. § 218d, for authority to)	Docket No. 7109
implement an Alternative-Regulation Plan)	
And Tariff Filing Requesting a 16.7% or a)	Docket No. 7160
18.3% Rate Increase)	

MEMORANDUM OF UNDERSTANDING ON ALTERNATIVE REGULATION

This Memorandum of Understanding, dated as of July 28, 2006 (the “MOU”), is between the Vermont Department of Public Service (“DPS”) and Vermont Gas Systems, Inc. (“VGS” or “the Company”).

Background

On September 1, 2005, VGS filed a petition (Docket No. 7109) for approval of an alternative-regulation plan (“ARP”) pursuant to 30 V.S.A. § 218d. On March 10, 2006, VGS filed revised tariffs (Docket No. 7160) reflecting a 16.7% increase in its rates, to take effect April 25, 2006, and to be implemented on a service-rendered basis commencing October 1, 2006 (Tariff Filing No. 7591). On March 15, 2006, the Company filed a letter asking the Public Service Board (“Board”) to consolidate, for purposes of hearings and administrative efficiency, Docket Nos. 7109 and 7160.

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

Throughout both dockets, the parties have engaged in far-reaching discovery. On January 25, 2006, and May 4, 2006, the Board held public hearings on the proposed ARP and the proposed rate change, respectively. The Board held a technical hearing regarding the Company's proposed ARP on June 5, 2006. The DPS and VGS have previously engaged in settlement negotiations and have settled certain matters pertaining to the Company's cost of service ("COS"), and they have subsequently engaged in settlement negotiations on the ARP.

Summary of Agreement

The subsequent negotiations between VGS and the DPS resulted in the agreement, set forth in this MOU, that the ARP should take effect, commencing on October 1, 2006, subject to the conditions contained herein.

AGREEMENT

VGS and DPS hereby stipulate to the settlement of the remaining issues between them in Docket Nos. 7109 and 7160 and specifically to the terms of the ARP as follows:

1. VGS agrees to amend Exhibit VGS-CWA-3 to modify the PGA (or "Purchased Gas Adjustment") mechanism described therein, and DPS will support implementation of the PGA as part of an ARP, if so amended, as follows:
 - a. The PGA shall be amended by VGS so that the Company will adjust rates quarterly on a bills-rendered basis.
 - b. The PGA shall be amended by VGS to provide that the "Adjustment" (as defined in Exhibit VGS-CWA-3), as modified by Subparagraph 1a of this MOU, will be the difference between the previous month's "Actual Gas Costs" (as so defined and net of interruptible and off-system revenue) and the "Actual Firm Gas Charge Revenue" (as so defined) but shall exclude

the first \$50,000, positive or negative, in each quarter or up to \$200,000 cumulatively in a gas year (the “PGA Deadband Amounts”).

- c. The PGA shall be amended by VGS to provide that the Company shall increase or decrease rates to share 90% of the gains or 90% of losses (as the case may be) that exceed the Deadband Sharing Amounts.
- d. The PGA shall be amended by VGS to provide that gains or losses to the Company under the PGA, resulting from the provisions added to the PGA as required by Subparagraphs 1b and 1c of this MOU, shall further be capped by the Earnings Sharing Mechanism proposed as part of the ARP, as amended in accordance with Paragraph 2 of this MOU.
- e. The methods and sources employed in developing the adjusted test year’s COS shall be used to guide calculation of the “12-Month Cost Forecast” (as defined in Exhibit VGS-CWA-3).
 - i. The PGA shall be amended by VGS, after review and with the advice of the DPS, to provide greater specificity regarding the methods and sources employed in developing the adjusted test year’s COS, and the amended PGA shall be filed with the Board within 30 days of this MOU’s approval.
 - ii. If the Company alters the methods or sources for calculating the 12-Month Cost Forecast during the term of this MOU, the Company agrees to amend the PGA to reflect changes in such sources or methods after review with the DPS and submit the amended PGA to the Board for its approval.

- iii. DPS agrees to recommend changes to the proposal (if any) within three weeks of such filing.
- 2. VGS agrees to amend Exhibit VGS-CWA-4 to modify the ESM or “Earnings Sharing Mechanism,” and DPS will support implementation of the ESM as part of the ARP, if so amended, as follows:
 - a. The ESM shall be amended by VGS to allow the Company annually to include increases or decreases associated with an “Over-earnings” or an “Earnings shortfall” (both as defined in Exhibit VGS-CWA-4) only to the extent that such Over-earnings or Earnings shortfall results in the Company earning a return, in a given fiscal year (ending on September 30), that exceeds or falls short of (as the case may be) the return on equity allowed in the COS by 50 basis points (the “ESM Deadband”).
 - b. The ESM shall also be amended by VGS to provide that annually the Company shall adjust its rates through the ESM to recover from firm customers 50% of the earnings that fall short of and return to firm customers a 75% share of earnings that exceed the ESM Deadband, provided that such sharing shall not apply to earnings that exceed or fall short of (as the case may be) the Company’s allowed return on equity (the “ROE”) by 200 basis points (the “ROE Cap”).
 - i. For clarity, if the Company’s earnings are 210 basis points above the allowed ROE, then 50 basis points would flow directly to the Company’s earnings as part of the deadband surrounding the ROE, 112.5 basis points or (75% of 150 basis points) would be returned

to ratepayers associated with the earnings-band sharing beyond the deadband, and 10 points would be returned to ratepayers as part of any earnings above the 200-basis-point ROE Cap, so that, all included, the Company would only earn 87.5 basis points above the allowed ROE.

ii. Conversely, if the Company's earnings are 210 basis points below the allowed ROE, then 50 basis points would flow directly to the Company's earnings as part of the deadband surrounding the ROE, 75 basis points or (50% of 150 basis points) would be collected from ratepayers associated with the earnings-band sharing beyond the deadband and 10 points would be collected from ratepayers as part of any earnings below the 200-basis-point ROE Cap, so that, all included, the Company would have earnings that are 125 basis points below the allowed ROE.

c. The ESM shall further be amended by VGS to change the definition of Authorized Revenue so that when Required Revenue is greater than the Revenue Cap, VGS shall return to or recover from its firm customers (as the case may be) one-half of the amount by which its Required Revenue exceeds or falls short of the Revenue Cap in accordance with Exhibit VGS-CWA-4, page 3.

i. For clarity, the only difference between the Required Revenue and the Revenue Cap is in the calculation of operating expenses.

- (a) For the ESM's Revenue Cap calculation, operating expenses shall be calculated as provided in the definition of Operating Costs Operating Costs in the ESM.
 - (b) For the ESM's Required Revenue calculation, operating expenses shall be calculated in accordance with traditional, cost-based ratemaking practices.
 - d. VGS confirms that the concepts of Required Revenue and Revenue Cap used in this MOU shall be as presented in the Company's Exhibit VGS-CWA-4.
 - e. Last, the ESM shall be amended by VGS to provide that the Company shall not have the right to adjust its rates through the ESM to recover costs resulting from Exogenous Factors (as defined in the ARP) until such costs exceed \$50,000 within any twelve-month fiscal year period during the ARP's term.
- 3. If the Board approves this MOU, the ARP as amended by this MOU and the COS stipulated in a separate MOU for Docket No. 7160, VGS and DPS agree:
 - a. that the customer addition during the ARP's term shall be rebuttably presumed to be the additional customers forecast by the Company over the next three years shown on Schedule 1;
 - b. that the customer additions shown on Schedule 1 depend on certain capital-expansion plans, that the Company shall notify the Department of the relationship between its customer forecast and capital-expansion plans at the onset of the ARP and inform the Department of any modifications to

those expansion plans that could impact estimates of customer additions and that notice of these adjustments shall be made by VGS with its annual COS filing;

- c. that DPS and VGS shall, however, in good faith negotiate a different forecast of customer additions if the Company or the DPS can demonstrate good cause therefor and, if they are unable to agree, that VGS or the DPS may, based on changed circumstances, submit for Board review and approval a different forecast of customer additions; and
 - d. that VGS shall amend the ESM to adjust its Authorized Revenue annually to reflect the customer addition as so forecast.
4. VGS and DPS agree that the COS of VGS under the ARP shall be determined based on traditional ratemaking policy, as established by Board precedent, including specifically that:
- a. the COS will be based on an historic and adjusted test year and will include the concept of weather normalization;
 - b. adjustments to costs from the historic to adjusted test year will be based on known and measurable changes;
 - c. VGS shall be entitled to recover expenses deferred in an Account Correcting for Efficiency (“ACE”) for prior demand-side-management (“DSM”) program measures implemented before the effective date of the ARP but shall only be entitled to recover ACE for DSM measures implemented after such date if the Board affirmatively concludes in this docket that the continuation of ACE for such programs is appropriate;

- d. expenses for DSM shall be amortized over a three-year period;
 - e. certain expenses, such as outside services and legal expenses, shall be determined using a three-year average; and
 - f. the COS shall exclude donations, lobbying expenses and other expenses not traditionally allowed in rates, as established by previous Board decisions.
5. VGS and DPS agree that the ARP shall be amended to provide:
- a. that quarterly, no later than the fifth-to-last business day of the month, VGS shall notify DPS and the Board of the PGA adjustment (if any) to be made beginning two months forward; by way of illustration, if VGS provides such notice on November 25 of any plan year, the adjustment would take effect on January 25;
 - b. notwithstanding Subparagraph 5a of this MOU, the first such notification shall not occur until February 2007 and quarterly thereafter (*i.e.*, May, August, November and February) to align the rate adjustments described in Paragraph 5d thereof;
 - c. that annually, no later than November 25 of any plan year, VGS shall notify the DPS and the Board of an increase or decrease (if any) in rates charged to firm customers to reflect changes to VGS' rates under the ESM, and the change in rates shall take effect on a bills-rendered basis no sooner than 60 days following such notice;
 - d. that annually, no later than August 15 of any plan year, VGS shall update estimates of actual customer additions for the current fiscal year, and

notify the DPS of any changes in its capital plans that would impact forecasts of customer additions and whether its estimates of customer additions adopted pursuant to Schedule 1 of this MOU should remain the forecast of customer additions.

- e. that VGS shall sequence the filing of any PGA adjustment to rates for the fourth quarter of any plan year and any annual adjustment to rates under the PGA such that both adjustments take effect on the same date; and
- f. that VGS shall provide customers with notice of each annual adjustment to rates under the ARP not less than thirty days before such adjustment.

6. VGS and the Department recognize that the implementation of this MOU will require the development of an effective and efficient format for timely reporting of and reviewing the information VGS is required to file periodically with the Department or with the Board during the term of the ARP.

- a. Accordingly, VGS and DPS agree that within 30 days of issuance of a final Board order approving this MOU, VGS shall submit to the Department a sample of each filing due to be made to the Department or the Board under the terms of the ARP as provided in this MOU.
- b. Thereafter, the Department shall have 30 days to comment on these proposed filing formats.
- c. VGS agrees to make such changes to the sample filing formats as the Department deems to be reasonably necessary to complete an efficient and meaningful review of the filings due under the ARP as provided in this MOU.

- d. Thereafter, VGS agrees to make such changes to the filing formats in the future as the Department deems to be reasonably necessary to complete an efficient and meaningful review of the filings due under this MOU.
7. VGS and DPS agree that under the ARP VGS shall offer by tariff an annual, fixed-price service to up to 30% of its firm customers, including up to 30% of its residential customers, no later than for the gas year commencing on November 1, 2007.
8. By January 31, 2007, VGS and DPS agree to develop jointly criteria to be used by DPS and VGS in assessing the ARP's effectiveness at the end of its initial term.
 - a. The criteria so developed shall be submitted to the Board.
 - b. Neither VGS nor DPS shall be bound to support termination or extension of the ARP beyond its initial term based solely on the criteria so developed.
9. This MOU provides a final resolution of all issues in Docket No. 7109, shall become effective upon the issuance of an order approving the MOU by the Board and shall be effective and binding on the parties only if the Board issues an order in this docket that is consistent in all respects with the terms of this MOU.
10. The parties agree that:
 - a. this MOU and any order approving this MOU relates only to these parties and shall not be construed as having precedential or any other impact on proceedings involving other utilities;
 - b. the parties have made compromises on specific issues to reach agreement on this MOU; and

- c. the MOU and any order approving this MOU shall not be construed by any party or tribunal as having precedential impact on any future proceedings involving the parties, except as necessary to ensure VGS's performance of this MOU or to enforce an order of the Board resulting from this MOU.
11. The parties agree that should the Board fail to approve the MOU in its entirety or in the event any modification or condition is made to this MOU by the Board, the parties' agreements set forth herein shall terminate, each party shall be placed in the position that it enjoyed in this proceeding before entering into the MOU and all negotiations and proceedings connected therewith shall be without prejudice to the rights of the parties.

Dated at Montpelier, Vermont this 28th day of July, 2006.

VERMONT DEPARTMENT OF PUBLIC SERVICE

By: _____
June E. Tierney

Dated at St. Johnsbury, Vermont, this 28th day of July, 2006.

VERMONT GAS SYSTEMS, INC.
By its attorneys, Downs Rachlin Martin PLLC

By: _____
John H. Marshall

Docket 7109/7160
Alternative Regulation Plan
Memorandum of Understanding
Schedule 1

Anticipated
Customer Growth (1)

Fiscal 2008	1,158
Fiscal 2009	1,290
Fiscal 2010	1,210

(1) Growth figures per VGS' 2006-1010 5 Year Plan