NATIONAL FUEL GAS DISTRIBUTION CORPORATION

MANAGEMENT EFFICIENCY INVESTIGATION

Evaluating the Implementation of

Selected Recommendations from the

2012 Focused Management and Operations

Audit Report

Prepared By The
Pennsylvania Public Utility Commission
Bureau Of Audits
Issued May 2015

Docket No. D-2014-2427061

PENNSYLVANIA PUC
PUBLIC UTILITY COMMISSION

NATIONAL FUEL GAS DISTRIBUTION CORPORATION
MANAGEMENT EFFICIENCY INVESTIGATION

TABLE OF CONTENTS

NATIONAL FUEL GAS DISTRIBUTION CORPORATION
MANAGEMENT EFFICIENCY INVESTIGATION

LIST OF EXHIBITS

I. INTRODUCTION

A. Background

In March 2011, the Management Audit Division (Audit Staff) of the Pennsylvania Public Utility Commission's (PUC or Commission) Bureau of Audits initiated a Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company). The Audit Staff subsequently completed its work and, in April 2012, issued a final report containing 12 recommendations for improvement. NFGDC submitted its Implementation Plan on April 26, 2012, indicating acceptance of ten recommendations and partial acceptance of two recommendations. On May 24, 2012, at D-2011-2228385, the Commission made both the audit report and Implementation Plan public and directed the Company to:

- Proceed with its April 26, 2012 Implementation Plan.

- Submit progress reports on the implementation annually, by May 1, for the next three years.

Since April 2012, NFGDC has submitted two Implementation Plan updates as requested by the Commission to ascertain the Company's progress in implementing the recommendations from the management audit report. Based on a review of these updates, the Audit Staff elected to conduct a Management Efficiency Investigation (MEI) of NFGDC's progress in implementing all of the original recommendations.

B. Objective and Scope

The objective of this MEI was to review and evaluate the effectiveness of NFGDC's efforts to implement the recommendations contained in the Focused Management and Operations Audit Report released in April 2012. The scope of this evaluation was limited to the Company's efforts in implementing all 12 prior management audit recommendations in the functional areas of:

- Executive Management & Organizational Structure
- Corporate Governance
- Affiliated Interests
- Financial Management
- Emergency Preparedness
- Diversity & Equal Employment Opportunity
- Customer Service

C. Approach

This MEI was performed by the Management Audit Staff of the PUC's Bureau of Audits (Audit Staff). Actual field work began on July 28, 2014 and continued through December 8, 2014. The fact gathering process included:

- Interviews with NFGDC personnel.

- Analysis of selected Company records, documents, reports, and other information for the period 2010 through 2014.

II. SUMMARY OF MANAGEMENT EFFECTIVENESS AND OPERATIONAL EFFICIENCY

The Audit Staff found that NFGDC has effectively or substantially implemented eight of the 12 prior Management Audit recommendations reviewed and has taken some action on the remaining four recommendations. Among the more notable improvements achieved by the management of the Company are:

- National Fuel Gas Company performed benchmarking of its external audit fees with peer companies prior to reviewing its contract with its external auditor and, after completing an analysis of the costs and benefits of changing firms, plans to formalize a recommended course of action with respect to rebidding by September 30, 2015.
- NFGDC filed an updated affiliated interest agreement with the Commission that includes all affiliates with whom the Company is transacting business.
- NFGDC has successfully reduced the amount of labor dollars allocated since 2010 by approximately 27%.
- NFGDC has established a formal dividend policy.
- NFGDC submitted to the Commission, within 30 days after public release of the April 2012 audit report, a detailed, written explanation for each dividend payment exceeding 85% of net income for fiscal years 2006-2011, and provided advance notice and a written explanation in June 2012 for a dividend payment expected to exceed 85% of net income to be paid in July 2012.
- NFGDC updated its Emergency Response Plan to include local police, fire, medical services and other local municipality contact information to ensure that all parties are made aware of pipeline emergency activities.
- NFGDC significantly increased its purchases from Minority-, Women-, and Persons With Disabilities-Owned vendors.
- NFGDC now tracks collection agency performance by state jurisdiction and has developed a collection agency performance report which tracks the net amounts collected by each collection agency.

While these accomplishments are commendable, the Audit Staff has identified further improvement opportunities in certain areas. In particular, NFGDC needs to:

- Enhance documentation in support of each reporting relationship with a high or low span of control as part of the annual organizational structure review.
- Complete the process to evaluate periodic rotation of the external audit firm and provide a recommendation to the Audit Committee of the Board of Directors.
- Establish a procedure to periodically assess external audit services fees either through a rebidding process or on the basis of a through benchmarking comparison.

- Periodically re-assess ring fencing practices and procedures in place, and, as necessary, strengthen its ring fencing position to insulate it from National Fuel Gas Company and its non-regulated affiliates.
- Continually strive to achieve full utilization of women and minorities in its workforce.

Exhibit II-1 summarizes the 12 prior recommendations reviewed and the Audit Staff's follow-up findings, conclusions, and recommendations.

NATIONAL FUEL GAS DISTRIBUTION CORPORATION
MANAGEMENT EFFICIENCY INVESTIGATION
SUMMARY OF APRIL 2012 MANAGEMENT AUDIT RECOMMENDATIONS AND STAFF'S FOLLOW-UP FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

Prior MA Recommendations	MEI Follow-up Findings And Conclusions	MEI Follow-up Recommendations
III. EXECUTIVE MANAGEMENT AND ORGANIZATIONAL STRUCTURE		
Examine the overall integrated management structure between National Fuel Gas Distribution Corporation and National Fuel Gas Company periodically and adjust reporting relationships, where appropriate, to eliminate unjustified low or high spans of control, and revise job titles based on reporting relationships and related responsibilities	**III-1 –** Departmental organization charts are routinely reviewed and job title revisions addressed as part of the annual operations and maintenance budgeting process; however, there is limited documentation to justify positions with high or low spans of control.	Enhance documentation in support of each reporting relationship with a high or low span of control as part of the annual organizational structure review.
IV. CORPORATE GOVERNANCE		
Rotate the external audit firm on a periodic basis.	**IV-1 –** National Fuel has formed a team of employees to evaluate rotation of the external audit firm and has begun to meet with representatives of alternative external audit firms.	Complete the process to evaluate rotation of the external audit firm and provide a recommendation to the Board of Directors' Audit Committee.
Periodically rebid and/or conduct cost comparisons of external audit services.	**IV-2 –** National Fuel Gas Company performed cost benchmarking of its external audit fees with peer companies prior to renewing its contract with PwC and plans to formalize a recommended course of action with respect to rebidding after completing an analysis of the costs and benefits of changing firms.	None.
	IV-3 – NFGDC has not established a procedure to periodically assess external audit service fees.	Establish a procedure to periodically assess external audit service fees either through a rebidding process or on the basis of a through benchmarking comparison.

NATIONAL FUEL GAS DISTRIBUTION CORPORATION
MANAGEMENT EFFICIENCY INVESTIGATION
SUMMARY OF APRIL 2012 MANAGEMENT AUDIT RECOMMENDATIONS AND STAFF'S FOLLOW-UP FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

Prior MA Recommendations	MEI Follow-up Findings And Conclusions	MEI Follow-up Recommendations
V. AFFILIATED INTERESTS		
Submit updated affiliated interest agreement(s) to the Commission for approval of all transactions with affiliates whom NFGDC transacts business.	**V-1 –** NFGDC filed an updated affiliated interest agreement with the Commission that includes all affiliates with whom NFGDC is transacting business.	None.
Initiate efforts to increase the amount of work hours within support service departments that are directly charged based on the task performed rather than allocated as a common cost.	**V-2 –**NFGDC has successfully reduced the amount of labor dollars allocated since 2010 by approximately 27%.	None.
Study possible alternatives for strengthening ring fencing by establishing procedures for obtaining external financing separate from the corporate parent and other appropriate measures.	**V-3 –** NFGDC has studied the feasibility and net benefit of obtaining external financing separate from National Fuel as part of its ring fencing review and has determined that it is more cost effective to have its parent company issue all debt and equity.	Periodically re-assess ring fencing practices and procedures in place and, as necessary, strengthen NFGDC's ring fencing position to insulate it from National Fuel and its non-regulated affiliates.
VI. FINANCIAL MANAGEMENT		
Establish a formal dividend policy.	**VI-1 –** NFGDC established a formal dividend policy in December 2014	None.
Submit a detailed, written explanation for each dividend payout exceeding 85% of net income to the Commission within 30 days after public release of the audit report, and ensure that advance notice and explanations are submitted to the Commission prior to making future dividend payments in excess of 85% of net income.	**VI-2 –** NFGDC submitted a detailed, written explanation to the Commission for dividend payments that exceeded 85% of NFGDC's net income and advance notice and a written explanation for an expected dividend payment that would be in excess of 85% of net income.	None.

NATIONAL FUEL GAS DISTRIBUTION CORPORATION
MANAGEMENT EFFICIENCY INVESTIGATION
SUMMARY OF APRIL 2012 MANAGEMENT AUDIT RECOMMENDATIONS AND STAFF'S FOLLOW-UP FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

Prior MA Recommendations	MEI Follow-up Findings And Conclusions	MEI Follow-up Recommendations
VII. EMERGENCY PREPAREDNESS		
Ensure that contact information for all local public and emergency officials as well as Pennsylvania State Police is included in the Company's Emergency Response Manual.	**VII-1 –** NFGDC has updated its Emergency Response Plan to include local police, fire, medical services and other local municipality contact information to ensure all parties are made aware of any emergency pipeline activities.	None.
VIII. DIVERSITY AND EQUAL EMPLOYMENT OPPORTUNITY		
Continue efforts to attain full utilization of women and minorities.	**VIII-1 –** The Company continues to experience the underutilization of women and minorities in certain job groups.	Continually strive to achieve full utilization of women and minorities in NFGDC-PA's workforce.
Implement additional strategies, initiatives, and actions as appropriate to increase purchases from women and persons with disabilities owned businesses.	**VIII-2 –** NFGDC has significantly increased its purchases from MWDBE vendors.	None.
IX. CUSTOMER SERVICE		
Track and report collection agency performance by state jurisdiction and include net collections as one of the performance measures used to evaluate each collection agency's results.	**IX-1 –** NFGDC currently tracks collection agency performance by state jurisdiction and has developed a collection agency performance report which tracks the net amounts collected by each agency.	None.

III. EXECUTIVE MANAGEMENT AND ORGANIZATIONAL STRUCTURE

Background – The Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company) issued in April 2012 at D-2011-2228385, contained one recommendation regarding the Executive Management functional area. The Audit Staff rated this functional area as needing minor improvement. In this chapter, the prior recommendation and prior situation are reviewed and one follow-up finding and recommendation are presented.

Prior Recommendation – Examine the overall integrated management structure between National Fuel Gas Distribution Corporation and National Fuel Gas Company periodically and adjust reporting relationships, where appropriate, to eliminate unjustified low or high spans of control, and revise job titles based on reporting relationships and related responsibilities.

Prior Situation – The Audit Staff found that a significant number of reporting relationships were outside of the commonly accepted span of control range of 1:4 to 1:9, and some job titles did not make sense based on their reporting relationships. As part of the review of NFGDC's organization structure, the Audit Staff reviewed the appropriateness of the spans of control at various key levels of management. Span of control refers to the number of subordinates a manager or supervisor directly supervises in an organization. To maximize organizational efficiency and effectiveness, the Company should ideally aim for a majority of its spans of control to be in the range of 1:4 to 1:9 to control layers of management and maintain effective communications. Overly narrow spans of control are considered inefficient because they can result in ineffective communications, micromanagement, unnecessary layers of supervision, and higher than necessary compensation costs. Spans of control that are too wide can result in poor communication and performance due to a lack of effective management oversight and control. The Audit Staff's analysis of NFGDC's spans of control for manager and supervisor positions, shown in Exhibit III-1, found that 46 of the 129 reporting relationships identified had a span of control of less than 1:4, while five had a span of more than 1:9.

There are situations where it is appropriate for a supervisor to have a span of control outside of the range from 1:4 to 1:9. For example, certain types of functions may require a position of authority to manage the function as opposed to managing employees (i.e., low spans of control), while other positions may manage a pool of employees that routinely perform a repetitive task (i.e., high spans of control).

The Audit Staff suggested that the reporting relationships should be periodically reviewed as part of an organization study designed to achieve and maintain the most effective and efficient organizational structure. It was also suggested that the organization study should also consider the job titles themselves and the reporting relationships of these job titles. For example, the Credit, Collections and Receivables Management Department organizational structure had a General Manager reporting to

Exhibit III-1
National Fuel Gas Distribution Corporation
Span of Control Analysis
June 30, 2011

Reporting Ratio	Number of Relationships
1:1	**12**
1:2	**19**
1:3	**15**
1:4	14
1:5	16
1:6	19
1:7	11
1:8	8
1:9	10
1:11	**2**
1:13	**3**
Total	129

Source: 2012 Focused Management and Operations Audit of NFGDC

an Assistant General Manager while the Finance Department organizational structure had a Treasurer reporting to the Controller who reported to an Assistant Treasurer (the Assistant Treasurer for NFGDC was also the Treasurer and Principal Financial Officer for the parent, National Fuel Gas Company). In both cases, there appeared to be a reporting relationship that was the opposite of what one would expect to see based on titles.

Follow-up Finding and Conclusion No. III-1 - Departmental organization charts are routinely reviewed and job title revisions addressed as part of the annual operations and maintenance budgeting process; however, there is limited documentation to justify positions with high or low spans of control.

Annually, in June, each NFGDC department presents its operations and maintenance (O&M) budget to NFGDC and National Fuel Gas Company officers. The officer-in-charge of Human Resources is one of the attendees. The following information is included in each department's presentation:

- Changes in complements and/or headcounts
- The number of anticipated personnel and their average wage rate
- Anticipated retirements or departures
- Job titles
- The use of loaned and borrowed labor
- Time reporting/charging practices
- Organizational charts, depicting spans of control, among other items

During the last round of budget meetings in June 2014, the organization structure for each functional area was reviewed. The Audit Staff reviewed a February 2014 memo sent by the Human Resources Department to all department heads indicating that organization charts were to be included as part of each department's budget presentation in June and that the charts were to be used in the ongoing review of spans of control. In addition, budget training held in March 2014 also stressed that organization charts were to be provided along with other budget information. During the budget meetings, the Vice President & General Counsel (the officer-in-charge of Human Resources) had the opportunity to further explore the above mentioned items during these presentations. After the O&M budget presentations, the Human Resources Department held additional meetings to discuss and address changes in NFGDC's organizational structure or spans of control. The Human Resources Department documented these meetings in an internal memorandum for the review process which was completed on September 9, 2014. The memorandum states that the Human Resources Coordinator reviewed the fiscal year 2015 departmental organization charts and then met with the General Manager of Human Resources to discuss three departments warranting further review:

- Accounting
- Consumer Business – New York
- Finance

The memo states that all other departments met the general span of control guidelines and/or were structured for maximum efficiency given the subject matters or areas of expertise within the respective department. The Human Resources Coordinator and General Manager of Human Resources then met with NFGDC's Vice President and General Counsel to discuss the areas warranting further review. Follow-up calls were made to department managers to discuss these areas. After more information was obtained, it was determined that the Consumer Business–New York and Finance departments were appropriately structured. The Accounting Department made an organizational change and provided an updated organizational chart which more clearly defined the reporting relationships and met the general span of control guidelines. Despite this process, the rationale for positions with high or low spans of control was not documented (i.e., the reasons for any position with a high or low span of control was not explained). In regards to job titles, some engineering job titles were revised. In addition, the title of General Manager, Credit, Collections and Receivables Management was changed to Director, Credit, Collections and Receivables Management.

The PUC Audit Staff reviewed the current organization charts for each department and queried the Company in regards to certain positions with high or low spans of control. The Company indicated that the Controller, for example, who has two direct reports, is responsible for managing a high-level financial accounting/finance function, as opposed to managing departmental employees on a day-to-day basis. This explanation seems reasonable considering the significant levels of responsibility held by the Controller. For other positions with high or low spans of control, the Audit Staff did not identify specific inefficiencies or poor performance resulting from high or low spans of control. Exhibit III-2 shows a recent analysis of spans of control based on organization charts as of July 30, 2014; 50 of the reporting relationships had fewer than four direct reports while five of the reporting relationships had more than nine direct reports.

Exhibit III-2
National Fuel Gas Distribution Corporation
Span of Control Analysis
July 30, 2014

Reporting Ratio	Number of Relationships
1:1	**18**
1:2	**19**
1:3	**13**
1:4	16
1:5	12
1:6	8
1:7	6
1:8	2
1:9	1
1:11	**2**
1:13	**1**
1:14	**1**
1:21	**1**
Total	100

Source: Data Request No. EM-2, Auditor Analysis

Any review process should include some form of documentation to demonstrate what occurred in the review process and the rationale for the decisions made in the process. NFGDC's Human Resources Department developed an internal memorandum to document departments with an organizational structure warranting further review but has not documented the reasons for each reporting relationship with a high or low span of control. Although NFGDC now has an annual process to review each department's organizational structure and assess the reporting relationships that exist, it does not document the results of the review, which makes it difficult to determine the reasonableness of certain reporting relationships as well as perform comparisons of the rationale over time. As of July 30, 2014, the number of reporting relationships with low/high spans of control has increased from 51 to 55 since June 30, 2011, and is limited documentation to explain the reasonableness of the vast majority of these reporting relationships.

<u>Staff's Follow-up Recommendation</u> – Enhance documentation in support of each reporting relationship with a high or low span of control as part of the annual organizational structure review.

IV. CORPORATE GOVERNANCE

<u>Background</u> – The Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company) issued in April 2012 at D-2011-2228385, contained two recommendations regarding the Corporate Governance functional area. The Audit Staff rated this functional area as needing minor improvement. In this chapter, two prior recommendations and prior situations are reviewed and two follow-up findings and recommendations are presented.

<u>Prior Recommendation</u> – Rotate the external audit firm on a periodic basis.

<u>Prior Situation</u> – National Fuel Gas Company (National Fuel), the parent of NFGDC, had used PricewaterhouseCoopers LLP (PwC) and its predecessor firms for its annual external audits since 1941. The lead partner for the external auditor was rotated beginning with fiscal year 2009 (the fiscal year ends on September 30), while the quality review partner was rotated beginning with fiscal year 2010; this met the requirement of the Sarbanes-Oxley Act of 2002. However, the Audit Staff advocated that it was prudent to periodically rotate the external audit firm.

When the same audit firm develops the overall audit approach and performs the annual audit steps, the auditors tend to become more and more complacent in the audit effort, thus lessening the objectivity of the audit. Therefore, the Audit staff asserted that it was a best practice to periodically rotate the external audit firm (i.e., every five to ten years). There likely would be a cost increase in performing the audit in the first year or two as a new firm would experience a learning curve to become familiar with the company's accounting systems, policies and procedures, etc. and therefore rotation more frequently than every five years likely would not be cost beneficial. On the other hand, by using the same audit firm for extended periods of time (i.e., the same firm since 1941), it is quite possible that familiarity will lead to complacency and that the objectivity of the audit will be reduced to the point that a fresh perspective is worth the additional cost of changing firms.

<u>Follow-up Finding and Conclusion No. IV-1</u> – National Fuel has formed a team of employees to evaluate rotation of the external audit firm and has begun to meet with representatives of alternative external audit firms.

An external audit firm subject matter team was formed in April 2013 in order to identify the requirements of prospective external audit firms. On an ongoing basis, this team also monitored the actions of the Public Company Accounting Oversight Board (PCAOB). During the summer of 2013, a list of five potential candidate firms was developed, including the incumbent. The timing of the implementation of this recommendation was delayed in order to match the timing specified for implementation of the same recommendation from an outside consultant in the Management Audit of NFGDC's New York Division. NFGDC envisions completing the process evaluating rotation of the external audit firm to meet the intent of both recommendations from the New York and Pennsylvania Divisions concurrently.

In February 2014, the NFGDC's subject matter expert team began to meet with representatives from external audit firms in order to differentiate offerings in service levels, depth and breadth of personnel, costs (hourly rates), relevant industry experience, geographic proximity, and assess each firm's ability to meet NFGDC's requirements. On February 10, 2014, the Company met with representatives from the first candidate firm, and on February 28, 2014, the Company met with representatives from the second candidate firm. The Company indicated that it had plans to conduct meetings with remaining candidate firm representatives by the end of 2014.

It should also be noted that during the first quarter of fiscal year 2014, at the conclusion of the normal five-year audit firm partner rotation cycle, a new PwC partner was assigned to the National Fuel Gas Company account. The Company indicated plans to evaluate the performance of this new PwC partner by the end of 2014. The Company has the following remaining steps in its process to evaluate potential rotation of the external audit firm:

- By July 1, 2015: finalize an analysis of qualitative and quantitative costs and benefits associated with preparing a Request For Proposal and transition costs that would be incurred should the Company decide to switch firms – comparing this to the base fees of the current external audit firm.

- By the end of the fiscal year ending on September 30, 2015: formalize a recommended course of action with respect to re-bidding based on the above analysis.

It should be noted that the decision for selecting/recommending an external audit firm resides with National Fuel's Board of Directors Audit Committee, and not NFGDC or National Fuel management. Ultimately, National Fuel shareholders vote annually on the ratification of an independent external auditor, as part of National Fuel's Proxy Statement.

Although mandatory audit firm rotation requirements have not gained traction for U.S. based companies despite endorsement from the Public Company Accounting Oversight Board among others, it is noteworthy that a mandatory audit firm rotation requirement and other audit market reforms have formally become part of European Union (EU) law. The EU requirement is that public interest entities—which include listed companies, banks, and insurance companies—change auditors after 10 years. This period can be extended to 20 years if the audit is put out for bid after 10 years, or 24 years in instances of joint audits, in which more than one firm conducts the audit. Consequently, the Audit Staff asserts that Pennsylvania Public Utilities, including National Fuel, should rotate their external audit firm on a periodic basis. National Fuel has used the same external audit firm for 73 years. Rotating the external auditor periodically would provide a fresh perspective to ensure an objective and independent opinion is issued with respect to the accuracy and fairness of National Fuel's annual financial statements.

<u>Staff's Follow-up Recommendation</u> – Complete the process to evaluate rotation of the external audit firm and provide a recommendation to the Board of Directors' Audit Committee.

<u>Prior Recommendation</u> – Periodically rebid and/or conduct cost comparisons of external audit services.

<u>Prior Situation</u> – National Fuel had not sought to rebid its external audit services. National Fuel indicated that it considered a variety of factors in support of its continued relationship with PwC. Some of these factors include the competitiveness of PwC's fees, benchmarking PwC's fees against the fees paid by other peer companies, and successful negotiation with PwC to hold fees at a constant rate. However, the Audit Staff advocated that a formal process of rebidding or performing a thorough cost comparison of external audit fees should be conducted every two to four years. Competitive bidding is a vehicle to ensure high-quality services (e.g., oversight) at the best overall value. It is also a way of encouraging fresh and more independent views/points of view.

<u>Follow-up Finding and Conclusion No. IV-2</u> - National Fuel Gas Company performed cost benchmarking of its external audit fees with peer companies prior to renewing its contract with PwC and plans to formalize a recommended course of action with respect to rebidding after completing an analysis of the costs and benefits of changing firms.

An audit fee benchmarking analysis was completed on October 13, 2014 in connection with National Fuel's contract extension with PwC (a two-year contract which expired on September 30, 2014). The analysis compared National Fuel's audit fees against 36 peer companies. National Fuel's audit fees as a percentage of revenue were 0.112%; the panel of companies audit fees as a percentage of revenue had a mean of 0.136% and a median of 0.100%. National Fuel Gas Companies audit fees as a percentage of assets were 0.031%; the panel of companies audit fees as a percentage of assets had a mean of 0.042% and a median of 0.031%. This analysis showed that National Fuel's audit fees were in line with the comparison companies in the analysis.

As discussed in Follow-Up Finding and Conclusion IV-1, a team of NFGDC employees was formed in April 2013 to identify requirements of prospective external audit firms. The team was also to monitor the actions of the Public Company Accounting Oversight Board on an on-going basis. The timing of implementation of this recommendation in Pennsylvania was delayed to coincide with implementation of a similar recommendation received regarding NFGDC's New York Division as discussed previously. National Fuel plans to formalize a recommended course of action with respect to rebidding by September 30, 2015 after completing an analysis of the costs and benefits of potentially changing firms.

<u>Staff's Follow-up Recommendation</u> – None.

Follow-up Finding and Conclusion No. IV-3 – NFGDC has not established a procedure to periodically assess external audit fees.

Although NFGDC has recently performed a benchmarking analysis of external audit service fees, the Company has not established a procedure to ensure an ongoing periodic rebidding of its external audit services or performing a periodic cost comparison of external audit service fees. The Audit Staff contends that it is a sound practice to establish a procedure for conducting a formal process of rebidding or performing a thorough cost comparison of external audit fees every two to four years. Such a process can ensure high-quality services (e.g., oversight) at the best overall value. It is also a way of encouraging fresh and more independent views/points of view.

Staff's Follow-up Recommendation – Establish a procedure to periodically assess external audit service fees either through a rebidding process or on the basis of a thorough benchmarking comparison.

V. AFFILIATED INTERESTS

<u>Background</u> – The Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company) issued in April 2012 at D-2011-2228385, contained three recommendations regarding the Affiliated Interests functional area. The Audit Staff rated this functional area as needing moderate improvement. In this chapter, three prior recommendations and prior situations are reviewed and three follow-up findings and two recommendations are presented.

<u>Prior Recommendation</u> – Submit updated affiliated interest agreement(s) to the Commission for approval of all transactions with affiliates whom NFGDC transacts business.

<u>Prior Situation</u> – Contracts or arrangements providing for transactions between affiliates must be filed with and approved by the Commission before they become effective. In addition, when substantive changes are made to service agreements, the contracts or arrangements should be updated and filed with the Commission. The Commission's authority to approve contracts between public utilities and their affiliates comes under its general authority to regulate public utilities in the Commonwealth, 66 C.S. §2102(a) which in part states:

> No contract or arrangement providing for the furnishing of management, supervisor, construction, engineering, accounting, legal, financial, or similar services, and no contract or arrangement for the purchase, sale, lease, or exchange of property, right, or thing or for the furnishing of any service, property, right or thing, other than those above enumerated, made or entered into after the effective date of this section between a public utility and any affiliated interest shall be valid or effective unless and until such contract or arrangement has received the written approval of the Commission.

The Audit Staff determined that NFGDC was transacting business with the following companies which were not included in the affiliated interest agreements that had been filed with and approved by the Commission:

- Horizon Power, Inc.
- National Fuel Gas Midstream Corporation
- Horizon LFG, Inc.

NFGDC acknowledged that there had been changes to the organizational structure since the last Commission approved affiliated interest agreement. As a result, NFGDC was not in compliance with 66 C.S. §2102(a) and needed to submit to the Commission, for approval, updated and/or amendments to the affiliated interest agreement(s) detailing all goods and services provided between NFGDC and its affiliates.

<u>Follow-up Finding and Conclusion No. V-1</u> – NFGDC filed an updated affiliated interest agreement with the Commission that includes all affiliates with whom NFGDC is transacting business.

On September 3, 2014, at Docket No. G-2014-2441017, NFGDC submitted an updated affiliated interest agreement (AIA) with the Commission. The Audit Staff found that the updated AIA, which had not yet been approved by the Commission as of the close of audit field work on December 8, 2014, includes all affiliates with whom NFGDC is transacting business and if approved by the PUC the Company would become compliant with 66 C.S. §2102(a).[1] The updated AIA is intended to replace the previous agreement dated January 4, 1993.

In general, the terms of the AIA filed in September 2014 direct that costs are to be directly assigned to the extent possible. If costs cannot be directly assigned, then they will be allocated based on cost-causative factors. Costs that cannot be directly assigned or allocated based on cost-causative factors will be allocated based on a five-factor formula including: gross plant, net plant, number of employees, operations and maintenance expenses, and total throughput. Exhibits in the updated AIA include a list of affiliates and the respective description of services provided by that affiliate under the agreement.

<u>Staff's Follow-up Recommendation</u> – None.

<u>Prior Recommendation</u> – Initiate efforts to increase the amount of work hours within support service departments that are directly charged based on the task performed rather than allocated as a common cost.

<u>Prior Situation</u> – An October 2008 National Fuel Gas Company (National Fuel) internal audit found that a considerable amount of support services labor hours were identified as common costs and allocated based on a five-factor allocation methodology and recommended that more efforts be made to directly assign and direct charge labor hours based on the specific tasks performed. The October 2008 internal audit of the common cost allocation process recommended that all departments providing common services should consider more closely tracking time spent on specific tasks and direct charge their work efforts where applicable. Additionally, the audit recommended that department managers and other necessary personnel be educated on a regular basis on common expense and how they impact the allocation of costs. Employees were to be encouraged to more closely track the time they spent on specific tasks in order to facilitate more direct charging of costs to the department benefitting from the work efforts. Labor charges which could be identified with a specific activity or project were to be directly charged to that specific activity or project.

The internal audit indicated that direct charging of expenses is more accurate in transferring the cost of services to the benefitting entity than using the common cost

[1] Upon completion of field work, the Audit Staff determined that the Commission approved the updated AIA on April 22, 2015 at Docket No. G-2014-2441017.

allocation process. NFGDC accepted the Audit Staff's recommendation indicating they would perform a study to identify departments that could increase the amount of labor hours which are direct charged. The Company identified the completion date for implementation of this recommendation as "On-going" in their April 2012 Implementation Plan and April 2013 and April 2014 Implementation Plan Updates.

<u>Follow-up Finding and Conclusion No. V-2</u> – NFGDC has successfully reduced the amount of labor dollars allocated since 2010 by approximately 27%.

During the annual operations and maintenance (O&M) budget presentation process held during June of 2013, each department provided an update of how their time was being charged. NFGDC management met with all common expense departments (e.g., accounting, human resources, internal audit, etc.) in February 2014 to review each department's specific tasks, determine which companies are impacted by those tasks, and encouraged direct charging of support services labor hours wherever possible. Certain departments indicated that they could direct charge more of their time. New supervisors, participating in the Supervisory Introductory Program, receive training on accounting charges and accounting charge application. This training is held one to two times per year; new supervisors receive this training within six months to one year of hire. During the 2015 O&M Budget Training held in March 2014, budget preparers, department heads and officers-in-charge of NFGDC departments were encouraged to direct charge their time, to the fullest extent possible, and avoid using common expense allocation formulas.

A Request For Proposal was issued in March 2014 to replace the legacy in-house developed mainframe-based 1980's time reporting system. The new time reporting system will be more fully integrated with the Company's PeopleSoft Financials Enterprise Resource Planning applications, facilitating more data analysis. The Company has selected a vendor and, as of July 2014, was negotiating with the vendor to establish a fixed price bid. The preliminary target date for deployment of the new time reporting system is February 2016. Once the new timekeeping system is installed and operational, a timekeeping section will be added to the Cost Assignment and Allocation Manual (CAAM). The CAAM, last updated in April 2014, is very comprehensive and explains in detail the Company's philosophy in regards to assigning and allocating costs among business units, among regulated services and non-regulated business activities, and among jurisdictions. The Applying Accounting Charges (AAC) manual, developed in the early to mid-2000's and updated in June 2014, was developed to provide guidance for properly applying accounting charges on transactions. The AAC manual describes each of the eight fields used in a transaction. The AAC manual also indicates that additional guidance can be obtained from the Accounting Department for questions related to accounting charges.

As of July 30, 2014, NFGDC was working with the New York State Public Service Commission to develop a three-factor allocation formula to replace the five-factor allocation formula which has been in use since the 1980's. The new formula would use total net plant, O&M expenses, and total throughput (in Mcf). The new allocation formula was made effective on October 1, 2014, at the start of NFGDC's 2015 fiscal year. On an on-going basis, an effort will be made to decrease the total pool of dollars which are allocated by encouraging each department to direct charge as much of their time as possible. This will be formally communicated throughout the organization as part of the installation of the new time keeping system, as described above. For the fiscal year ended September 30, 2013, the total pool of dollars subject to common cost allocation was $8.1 million. Of this amount, $1.0 million (12.5%) was allocated to NFGDC's Pennsylvania Division (NFGDC-PA). Labor dollars allocated to NFGDC-PA for the fiscal years 2010 through 2014 are shown in Exhibit V-1. The amount of labor dollars allocated to NFGDC-PA decreased by 26.6% over this period.

Exhibit V-1
Labor Dollars Allocated to NFGDC-PA
For the Fiscal Years 2010 through 2014

2010	**$1,008,578**
2011	**$953,595**
2012	**$900,650**
2013	**$839,014**
2014	**$739,925**

Source: NFGDC's comments to MEI draft report

Direct charging of labor hours is a more accurate method for transferring the cost of services to the benefitting entity versus using the common cost allocation process. Therefore, employees should monitor the time they spend on specific tasks or projects and directly charge as much time as possible to the department(s) benefitting from their work efforts. It should be noted that all employee time cannot be direct charged, as NFGDC employees may at times perform work for multiple subsidiaries, due to the company's unique organizational structure, on behalf of the whole National Fuel system. For example, a corporate communications employee may develop and issue an internal communication to all employees. This work does not lend itself to direct charging since it benefits all subsidiaries within the National Fuel system. NFGDC believes that an allocation formula makes sense to use for work that is being completed on behalf of multiple subsidiaries. However, NFGDC has and continues to encourage employees to directly charge their time to the maximum extent possible. A common cost allocation internal audit is scheduled to be performed as part of the 2015 Audit Plan.

Staff's Follow-up Recommendation – None.

Prior Recommendation – Study possible alternatives for strengthening ring fencing by establishing procedures for obtaining external financing separate from the corporate parent and other appropriate measures.

Prior Situation –The objective of ring fencing is to ensure that the financial stability of the utility and the reliability of its service are not impacted by the activities of non-regulated corporate activities. The ring fencing practices that National Fuel had in place to insulate NFGDC from the activities of National Fuel and its other subsidiaries included separate NFGDC bank accounts that were not commingled with the funds of its sister companies, and the use of a Money Pool by National Fuel Gas Company and its subsidiaries (including NFGDC) to manage short-term financing needs. NFGDC has the ability to borrow from the Money Pool but it may not invest excess cash into the Money Pool. NFGDC also has borrowing priority over other subsidiaries if there are insufficient funds available from Money Pool sources to satisfy the Money Pool borrowing requirements of the subsidiaries.

However, National Fuel manages its capital structure on a consolidated basis, with all capital obtained by the parent company and allocated to the subsidiaries, including NFGDC. This financing approach had enabled NFGDC to receive better financing rates and incur lower financing costs by receiving proceeds from bonds issued through National Fuel Gas Company than it would have achieved by issuing its own debt. Through this arrangement, NFGDC was relying on its corporate parent for all of its financing needs which includes operations in much riskier business segments such as exploration and production, energy marketing, pipeline and storage, etc. Due to the extensive nature of National Fuel's unregulated affiliates' higher risk business activities, the Audit Staff felt that NFGDC should be exploring more extensive ring fencing practices. The Audit Staff suggested that it would be beneficial for NFGDC to also have direct access to its own external financing should the interest rates obtainable by National Fuel become unfavorable or borrowing would become impossible due to unexpected problems with its unregulated affiliates business activities. In its April 2012 Implementation Plan, NFGDC indicated it would study the feasibility and net benefit of obtaining external financing separate from the corporate parent and other appropriate measures.

<u>Follow-up Finding and Conclusion No. V-3</u> – NFGDC has studied the feasibility and net benefit of obtaining external financing separate from National Fuel as part of its ring fencing review and has determined that it is more cost effective to have its parent company issue all debt and equity.

NFGDC performed an analysis of the costs of obtaining external financing through its parent company versus the costs of obtaining external financing on its own. This analysis considered committed credit facility fees along with accounting/audit fees. NFGDC's average annual external financing costs are approximately $750,000 when all credit is issued by National Fuel. However, these costs would increase to approximately $1.1 million if NFGDC were to obtain external financing on its own.

National Fuel maintains a $750 million syndicated committed credit facility and $335 million of discretionary lines of credit with its relationship banks (collectively the "Credit Facilities"). These Credit Facilities support the National Fuel Gas Company Money Pool, against which NFGDC has priority borrowing rights ahead of all other National Fuel subsidiaries. As of April 4, 2014, National Fuel had zero borrowings outstanding under its Credit Facilities and NFGDC's borrowings under the Money Pool were also zero. NFGDC also indicated that neither National Fuel nor NFGDC faced any significant financing requirements in the near term. In particular, National Fuel's next long-term debt maturity is for $300 million in April 2018, of which NFGDC's share is to be $100 million. Management further stated the following in support of its contention that sufficient ring fencing measures are currently in place:

- The principal ring fencing measure occurs through the Money Pool.
    - NFGDC can borrow from the Money Pool but it cannot invest excess cash in the Money Pool.
    - NFGDC has first priority on borrowings from the Money Pool.
    - The Money Pool interest rate is based on the commercial paper rate.
- The parent company issues all debt and equity, and contends that it is more efficient to have one single credit issuance which is shared by all affiliates, as opposed to NFGDC having direct access to external financing, separate from the parent.
- NFGDC maintains separate bank accounts and does not commingle its funds with affiliates.
- The principal amount of all subsidiary debt to outside parties may not exceed 15% of the consolidated assets of National Fuel.

A sufficient level of ring fencing will insulate a regulated utility from the potentially riskier activities of unregulated affiliates. This includes establishing procedures for obtaining external financing separate from the corporate parent. It is NFGDC's position that present ring fencing provisions are sufficient and that it is more efficient to obtain financing through National Fuel. While it appears to be true that NFGDC's financing is less costly via use of National Fuel's consolidated financing (estimated savings of $350,000 per year); nonetheless, NFGDC's financial stability and the reliability of its service is susceptible to the impact from the activities of its non-regulated affiliates. This includes the potential that financing might not be available from National Fuel or its borrowing rates could become too high, resulting in insufficient funds to maintain regular operations.

<u>Staff's Follow-up Recommendation</u> – Periodically re-assess ring fencing practices and procedures in place and, as necessary, strengthen NFGDC's ring fencing position to insulate it from National Fuel and its non-regulated affiliates.

VI. FINANCIAL MANAGEMENT

<u>Background</u> – The Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company) issued in April 2012 at D-2011-2228385, contained two recommendations regarding the Financial Management functional area. The Audit Staff rated this functional area as needing minor improvement. In this chapter, two prior recommendations and prior situations are reviewed and two follow-up findings and one recommendation are presented.

<u>Prior Recommendation</u> – Establish a formal dividend policy.

<u>Prior Situation</u> – National Fuel Gas Company (National Fuel) did not have a corporate dividend policy related to the payment of dividends from the regulated utility (i.e., NFGDC) to its parent corporation (i.e., National Fuel). Dividend payments from regulated utilities to holding or parent companies typically range from 75% to 85% of net income. For 2006 through 2011, NFGDC-PA's dividend payments to its parent corporation averaged 111% of net income, including dividends paid as a percentage of net income of 209% in 2006, 149% in 2007, 128% in 2010, and 125% in 2011. Such dividend payments are not sustainable for long periods of time without borrowing significant amounts to sustain ongoing operations. The establishment of a formal dividend policy would set sound business parameters from which to base dividend payouts.

<u>Follow-up Finding and Conclusion No. VI-1</u> – NFGDC established a formal dividend policy in December 2014.

NFGDC indicated in its April 2012 Implementation Plan that it would complete the implementation of this recommendation by April 2013. Subsequently, the Company indicated it would complete this recommendation by December 2013 in its April 2013 Implementation Plan Update and then by June 2014 in its April 2014 Implementation Plan Update. The formal dividend policy was completed in December 2014.

NFGDC has indicated that it is targeting a 50% equity/50% debt capital structure. This is consistent with the equity component of peer natural gas distribution companies (NGDCs); based on a June 2012 survey developed by NFGDC that showed an average equity component for 11 other NGDCs of 51.2% and a median equity component of 49.9%. NFGDC reportedly monitors its cash flow and capital structure quarterly, and when the equity ratio becomes high (i.e., above 50%), adjustments are made to dividends in order to reduce the equity ratio. NFGDC also stated that any debt proceeds from the securities filing as approved at S-2014-2429368, to be issued in 2014 or thereafter, would not be used to fund a dividend payment. Every Pennsylvania regulated public utility is required to acquire prior approval from the Commission before it issues or assumes securities, per 66 Pa. C.S. §1901. As of October 14, 2014, there were no debt issuances from this securities filing. The initial target completion date for developing a dividend policy was extended to December 2014 to coincide with implementation of a similar recommendation from a management audit completed for the New York State Public Service Commission which was as follows: Develop a formal dividend policy designed to optimize the use of available funds for NFGDC-NY and National Fuel while maintaining an appropriate debt/equity structure. NFGDC's intent was to complete the requirements of the audits in both New York and Pennsylvania jurisdictions concurrently.

Staff's Follow-up Recommendation – None.

Prior Recommendation – Submit a detailed, written explanation for each dividend payout exceeding 85% of net income to the Commission within 30 days after public release of the audit report, and ensure that advance notice and explanations are submitted to the Commission prior to making future dividend payments in excess of 85% of net income.

Prior Situation – During 2006-2011, NFGDC's dividends payments to National Fuel significantly exceeded its net income and averaged 111% of net income for the period. The dividend payout ratio was as high as 209% in 2006. The Audit Staff found no evidence that NFGDC's financial strength, service/reliability and/or safety had been affected by the high dividend payouts that had occurred since 2006. However, the Commission has an obligation to ensure that a public utility's dividend practices do not harm NFGDC's financial strength, service/reliability and/or safety. Consequently, the Audit Staff recommended that NFGDC should provide advance notice of, and an explanation for, annual dividend payments in excess of 85% of net income as circumstances warrant.

Follow-up Finding and Conclusion No. VI-2 – NFGDC submitted a detailed, written explanation to the Commission for dividend payments that exceeded 85% of NFGDC's net income and advance notice and a written explanation for an expected dividend payment that would be in excess of 85% of net income.

On June 21, 2012, NFGDC submitted a written explanation to the Commission regarding the dividend payments that exceeded 85% of its net income for the years 2006-2011. At the same time, the Company also provided advance notice to the Commission and a written explanation for an expected dividend payment on July 12, 2012 of 113.7% of its net income. According to the Company, the higher dividend payouts were the direct result of management's approach to managing NFGDC's capital structure. The Company indicated that the expected dividend payment in July 2012 (for fiscal year 2012) would reduce the actual equity component from 57.6% on April 30, 2012 to a projected equity component of 55.5% on September 30, 2012. NFGDC-PA had a dividend payout ratio of 40.7% of net income in fiscal year 2013 and 41.6% in fiscal year 2014.

Staff's Follow-up Recommendation – None.

VII. EMERGENCY PREPAREDNESS

Background – The Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company), conducted by the Management Audit Division (Audit Staff) of the Pennsylvania Public Utility Commission (PUC or Commission) released on May 24, 2012 at D-2011-2228385, contained one recommendation within the Emergency Preparedness functional area. The Audit Staff rated this functional area as needing minor improvement. In this chapter, the one prior recommendation and prior situation are reviewed and one follow-up finding is presented. In addition, the Audit Staff deemed it prudent to perform an updated review of the Company's compliance with PUC regulations at 52 Pa. Code §101 regarding physical security, cyber security, emergency response and business continuity plans as part of this audit.

In order to protect infrastructure within the Commonwealth of Pennsylvania and ensure safe, continuous and reliable utility service, effective since June 2005, PUC regulations at 52 Pa. Code §101 (Chapter 101) require all jurisdictional utilities to develop and maintain written physical security, cyber security, emergency response and business continuity plans. Furthermore, in accordance with 52 Pa. Code §101.1, all jurisdictional utilities are to annually submit a Self Certification Form to the Commission documenting compliance with Chapter 101. This form, available on the PUC website, is comprised of 13 questions as shown in Exhibit VII-1.

Exhibit VII – 1
Pennsylvania Public Utility Commission
Public Utility Security Planning and Readiness Self Certification Form

Item No.	Classification	Response (Yes – No – N/A*)
1	Does your company have a physical security plan?	1.
2	Has your physical security plan been reviewed in the last year and updated as needed?	2.
3	Is your physical security plan tested annually?	3.
4	Does your company have a cyber security plan?	4.
5	Has your cyber security plan been reviewed in the last year and updated as needed?	5.
6	Is your cyber security plan tested annually?	6.
7	Does your company have an emergency response plan?	7.
8	Has your emergency response plan been reviewed in the last year and updated as needed?	8.
9	Is your emergency response plan tested annually?	9.
10	Does your company have a business continuity plan?	10.
11	Does your business continuity plan have a section or annex addressing pandemics?	11.
12	Has your business continuity plan been reviewed in the last year and updated as needed?	12.
13	Is your business continuity plan tested annually?	13.

* Attach a sheet with a brief explanation if N/A is supplied as a response to a question.
Source: Public Utility Security Planning and Readiness Self-Certification Form, as available on the PUC website at http://www.puc.state.pa.us/general/onlineforms/pdf/Physical_Cyber_Security_Form.pdf.

While conducting our Management Efficiency Investigation, the Audit Staff reviewed the most recent (2013) Self Certification form submitted by NFGDC to determine the status of its responses. Our examination of the Company's emergency preparedness included a review of the Physical Security Plan (PSP), Cyber Security Plan (CSP), Emergency Response Plan (ERP), Business Continuity Plan (BCP), and associated security measures.

Each of the plans are overseen and managed by various groups and individuals within the Company. These groups are in charge of overseeing the testing, reviewing, and updating of their respective plan. The individuals and their department(s) assigned to each plan are as follows:

- Physical Security Plan – Assistant General Manager, Security
- Cyber Security Plan – General Manager, Information Services
- Emergency Response Plan – Assistant Vice President and Vice President, National Fuel Gas Distribution Corporation
- Business Continuity Plan – General Manager, Operations Compliance

Due to the sensitive nature of the information reviewed, specific information is not revealed in this report but rather the generalities of the information reviewed are summarized.

<u>Prior Recommendation</u> – Ensure that contact information for all local public and emergency officials as well as Pennsylvania State Police is included in the Company's Emergency Response Manual.

<u>Prior Situation</u> – The Company's Emergency Response Plan contained numerous outside contacts needed for emergency situations, for example:

- National Fuel Contacts
  - National Fuel Gas Operations Center Contacts – Mineral Springs, NY
  - NFGDC Gas Operation Pennsylvania Service Center Contacts
  - Supply Corporation Pennsylvania Contacts
  - Recovery Coordinator and Incident Managers
  - Senior Officers, Risk Management and Security Department Contacts
- Pennsylvania Public Utility Commission
- Department of Transportation National Response Center
- County Reach Emergency Numbers
- Daily Newspaper, Radio and Television station and Pennsylvania Energy Association Contacts
- County Emergency Management Coordinators

However, the Audit Staff's review of the emergency response manual revealed that information for service territories emergency responders (i.e., police, fire, and emergency medical services) was absent. Additionally, there was no contact information for the Pennsylvania State Police barracks. In some cases, small municipalities do not have local law enforcement and are therefore patrolled by the

Pennsylvania State Police. The Audit Staff noted that the company's previous acceptable practice was to call 911 centers directly during emergencies (especially in rural areas). However, the Company should have all local emergency responder and state police information documented. This information should be updated annually for the following reasons:

- Recommended Practice 1162, developed by gas pipeline operators in response to the Pipeline Safety Improvement Act (passed by Congress in December 2002), states that all local public and emergency officials must be made aware of pipeline safety activities involving the local gas distribution company.
- During an emergency situation there may become a need for assistance from or information needed from local emergency providers.
- During an emergency situation there may become a need for assistance from or information needed from state police barracks, in areas where there is no local enforcement agency.

Follow-up Finding and Conclusion No. VII-1 – NFGDC has updated its Emergency Response Plan to include local police, fire, medical services and other local municipality contact information to ensure all parties are made aware of any emergency pipeline activities.

The Company updated its ERP in July 2012 to include all necessary contacts, including local emergency service contacts, in case of emergencies. The Company has a dedicated Standards Team in charge of NFGDC's ERP, BSP, CSP and BCP. The Standards Team reviews the contact list annually and updates the list as needed to ensure the most current information for all emergency contacts in their service territories.

Staff's Follow-up Recommendation – None.

VIII. DIVERSITY AND EQUAL EMPLOYMENT OPPORTUNITY

Background – The Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company), conducted by the Management Audit Division (Audit Staff) of the Pennsylvania Public Utility Commission's (PUC or Commission) Bureau of Audits released on May 24, 2012 at D-2011-2228385, contained two recommendations within the Human Resources functional area. The Audit Staff rated this functional area as needing minor improvement. In this chapter, the two prior recommendations and prior situations are reviewed and two follow-up findings and one recommendation are presented. Additionally the Audit Staff deemed it prudent to expand the scope of the MEI to determine if the Company has continued to file the required PUC Annual Diversity Reports.

The Commission has encouraged utilities to proactively improve diversity in their workforces and purchasing efforts for more than 19 years. More specifically, on February 13, 1992, the Commission approved a motion to make diversity an integral part of the management audit process and to direct utilities to file quarterly status reports. On March 16, 1992, a secretarial letter was issued by the Commission directing all jurisdictional utilities affected by Section 516 of the Public Utility Code (i.e., utilities, whose plant-in-service exceeds $10,000,000) to file certain diversity information to the Commission quarterly. On May 18, 1994, the Commission issued an order directing these utilities to file diversity status reports on a semi-annual rather than quarterly basis, to submit EEO plans annually, and to file certain diversity data. Additionally, in February 1995, the Commission adopted a "Policy Statement Regarding Diversity at Major Jurisdictional Utility Companies" (entered into the regulations at 52 Pa. Code §69.801-69.809), which encourages the utilities to include diversity efforts as a component of their business strategy. Later, in March 1997, the Commission issued diversity filing requirement clarifications and revisions, which most significantly changed the filing requirements from semi-annual to annual.

Prior Recommendation – Continue efforts to attain full utilization of women and minorities.

Prior Situation – A summary of NFGDC's utilization of women and minority employees based in Pennsylvania, as of December 31, 2010, is shown in Exhibit VIII-1. As of year-end 2010, women were underutilized in six job groups, and minorities were underutilized in two job groups. Total female underutilization was 27 employees, while total minority underutilization was 3 employees. Female underutilization occurred in the Executive/Senior Level Officials, First/Mid-Level Officials, Professionals, Craft Workers, Operatives, and Laborers & Helpers job groups. Minority underutilization occurred in the Operatives and Laborers & Helpers job groups.

Exhibit VIII-1
National Fuel Gas Distribution Corporation
Utilization Analysis for Employees Based in Pennsylvania
As of December 31, 2010

Job Group	Total Number of Employees	Women				Minorities			
		Utilization		Availability Percent	Number Under-Utilized	Utilization		Availability Percent	Number Under-Utilized
		Number	Percent			Number	Percent		
Executive/Senior Level Officials	14	2	14.3%	23.3%	1	0	0.0%	4.7%	0
First/Mid-Level Officials	43	10	23.3%	39.9%	7	2	4.7%	4.2%	0
Professionals	21	9	42.9%	57.6%	3	1	4.8%	6.3%	0
Technicians	3	1	33.3%	59.2%	0	0	0.0%	7.9%	0
Craft Workers	33	0	0.0%	4.0%	1	2	6.1%	4.8%	0
Operatives	103	3	2.9%	16.2%	13	5	4.9%	7.5%	2
Laborers & Helpers	19	1	5.3%	16.7%	2	1	5.3%	11.9%	1
Administrative Support Workers	98	79	80.6%	76.8%	0	10	10.2%	7.0%	0
Totals	334	105	31.4%		27	21	6.3%		3

Source: National Fuel Gas Distribution Corporation 2011 Affirmative Action Plan

Follow-up Finding and Conclusion No. VIII-1 – The Company continues to experience the underutilization of women and minorities in certain job groups.

NFGDC currently uses the Erie, Pennsylvania metropolitan statistical area (MSA) for the evaluation of utilization of its employees located in its Pennsylvania operating area. The Erie MSA has a higher availability of woman and minorities than the MSAs of smaller towns and communities in the region. Therefore, use of the Erie MSA makes more difficult utilization levels to achieve a diverse workforce.

The Company Human Resource Department continues to develop diverse relationships in the Pennsylvania operating territory as follows:

- All NFGDC's jobs located in Pennsylvania are listed on the Commonwealth's Workforce Development System (PA Careerlink).
- Employment opportunities are sent to the Multicultural Community Resource Center and the Greater Erie Community Action Committee.
- Employment opportunities are also posted with the Wounded Warrior Project and Veterans Affairs Medical Center.
- NFGDC builds relationships and conducts site visits to local colleges and universities.
- NFGDC maintains a Job Posting program and offers counseling to employees concerning the enhancement of their qualifications for desired promotional opportunities.

An updated Utilization Analysis for year-end 2013 is shown in Exhibit VIII-2. From 2010 to 2013, NFGDC staffing decreased by one employee; 334 to 333 (-0.3%).

Total female underutilization increased by one (3.7%) from 27 in 2010 to 28 in 2013. Total minority underutilization more than doubled, rising from 3 in 2010 to 8 in 2013. Most job groups stayed about same, with little or no change in underutilization. However, minority underutilization in the "Operatives" Job group increased from 3 to 7.

Exhibit VIII-2
National Fuel Gas Distribution Corporation
Utilization Analysis for Employees Based in Pennsylvania
As of December 31, 2013

Job Group	Total Number of Employees	Women				Minorities			
		Utilization		Availability Percent	Number Under-Utilized	Utilization		Availability Percent	Number Under-Utilized
		Number	Percent			Number	Percent		
Executive/Senior Level Officials	11	1	9.1%	27.3%	2	0	0.0%	3.6%	0
First/Mid-Level Officials	55	15	27.3%	40.9%	7	2	3.6%	6.0%	1
Professionals	17	7	41.2%	58.2%	2	1	5.9%	5.9%	0
Technicians	2	0	0.0%	66.5%	1	0	0.0%	5.4%	0
Craft Workers	27	0	0.0%	3.4%	1	1	3.7%	6.8%	0
Operatives	103	2	1.9%	16.4%	14	2	1.9%	8.0%	6
Laborers & Helpers	18	2	11.1%	17.1%	1	1	5.6%	12.6%	1
Administrative Support Workers	100	80	80.0%	75.5%	0	9	9.0%	7.7%	0
Totals	333	107	32.1%		28	16	4.8%		8

Source: Data Request DIV-011

<u>Staff's Follow-up Recommendation</u> – Continually strive to achieve full utilization of women and minorities in NFGDC-PA's workforce.

<u>Prior Recommendation</u> – Implement additional strategies, initiatives, and actions as appropriate to increase purchases from women and persons with disabilities-owned businesses.

<u>Prior Situation</u> – From 2006 to 2010, NFGDC's total purchases increased 14.4% while purchases from minority, women, and persons with disabilities owned businesses (MWDBEs) declined by 47.9%. More specifically, purchases from minority-owned businesses (MBE) during this period increased by approximately $102,000, or 19.3%, while purchases from women-owned businesses (WBE) decreased by approximately $1.5 million, or 62.1%. Purchases from persons with disabilities owned businesses (DBE) increased from $0 in 2006 to $49,777 in 2008, and then decreased to $2,849 in 2010. NFGDC's purchases from MWDBEs during the period 2006 through 2010 are summarized in Exhibit VIII-3. These are purchases for both the New York and Pennsylvania Divisions.

Exhibit VIII-3
National Fuel Gas Distribution Corporation
Purchases Made From
Minority/Women/Persons With Disabilities-Owned Business Enterprises
For the Years 2006 through 2010

Year	Minority-Owned Purchases	% of Total Purchases	Women-Owned Purchases	% of Total Purchases	Persons With Disabilities-Owned Purchases	% of Total Purchases	Total MWDBE Purchases	% of Total Purchases	Total Purchases
2006	$526,722	0.69%	$2,503,536	3.28%	$0	0.00%	$3,030,258	3.97%	$76,424,859
2007	$261,804	0.35%	$1,683,949	2.25%	$6,175	0.01%	$1,951,928	2.60%	$75,001,395
2008	$562,097	0.62%	$1,441,616	1.60%	$49,777	0.06%	$2,053,490	2.28%	$90,037,708
2009	$726,352	0.88%	$949,532	1.15%	$27,647	0.03%	$1,703,531	2.07%	$82,492,593
2010	$628,286	0.72%	$948,521	1.09%	$2,849	0.00%	$1,579,656	1.81%	$87,415,992
% Change*	**19.3%**		**-62.1%**		**-53.9%**		**-47.9%**		**14.4%**

* Note that the percentage change for Minority-Owned purchases and Women-Owned purchases is based on the period 2006-2010, the percentage change for Persons With Disabilities-Owned purchases is based on the period 2007-2010, and the percentage change for Total MWDBE Purchases and Total Purchases is based on the period 2006-2010.

Source: Exhibit VIII-3 from the 2012 Focused Management and Operations Audit of National Fuel Gas Distribution Corporation at D-2011-2228385

Follow-up Finding and Conclusion No. VIII-2 – NFGDC has significantly increased its purchases from MWDBE vendors.

As shown in Exhibit VIII-4, NFGDC's total purchases increased by 15.8% from 2010 to 2013. For the same time period, minority-owned, women-owned and persons with disability-owned vendor purchases increased by approximately 30%, 325%, and 1,840%, respectively. Most notable is the increase in purchases made from women-owned vendors; spending increased from $948,521 in 2010 to about $4.0 million in 2013. This growth is attributed to two prior existing vendors self-identifying as woman owned businesses. Once a vendor self-identifies, an NFGDC employee verifies that the vendor qualifies as a MWDBE in order to be eligible for and tracked as an MWDBE for procurement purposes.

Exhibit VIII-4
National Fuel Gas Distribution Corporation
Purchases Made From
Minority/Women/Persons With Disabilities-Owned Business Enterprises
2010 – 2013

Year	Minority-Owned Purchases	% of Total Purchases	Women-Owned Purchases	% of Total Purchases	Persons With Disabilities-Owned Purchases	% of Total Purchases	Total MWDBE Purchases	% of Total Purchases	Total Purchases
2010	$628,286	0.72%	$948,521	1.09%	$2,849	0.00%	$1,579,656	1.81%	$87,415,993
2011	$1,521,143	1.74%	$1,666,053	1.90%	$68,056	0.08%	$3,255,252	3.72%	$87,499,338
2012	$1,009,723	1.14%	$1,951,086	2.20%	$9,556	0.01%	$2,970,365	3.35%	$88,620,615
2013	$814,319	0.80%	$4,030,441	3.98%	$55,297	0.05%	$4,900,057	4.84%	$101,266,283
% Change	**29.6%**		**324.9%**		**1840.9%**		**210.2%**		**15.8%**

Source: Data Request DIV-11

Staff's Follow-up Recommendation – None.

IX. CUSTOMER SERVICE

<u>Background</u> – The Focused Management and Operations Audit of National Fuel Gas Distribution Corporation (NFGDC or Company) issued in April 2012 at D-2011-2228385, contained one recommendation regarding the Customer Service functional area. The Audit Staff rated this functional area as needing moderate improvement. In this chapter, one prior recommendation and prior situation are reviewed and one follow-up finding is presented.

<u>Prior Recommendation</u> – Track and report collection agency performance by state jurisdiction and include net collections as one of the performance measures used to evaluate each collection agency's results.

<u>Prior Situation</u> – NFGDC was not tracking the individual performance of each collection agency it used nor was it tracking collections performance separately by state jurisdiction. NFGDC used outside collection agencies after first attempting to recover inactivated accounts with in-house staff. Collection agency performance was tracked on a consolidated basis for both Pennsylvania and New York service territories. A report was generated monthly showing each collection agency's performance by receivable segment. The performance of each agency handling a specific segment was analyzed and the highest performing agency, based on adjusted gross recovery rates, was designated the top performer. Due to the somewhat cyclical nature of recoveries, the top performer's recovery rate was adjusted (normally between 0.10% and 1.25%) and that level of performance became the goal for that particular receivable segment the following month.

The Audit Staff recommended that NFGDC track net collection recovery performance; net collections reflect the percentage of original accounts receivable amounts assigned to a specific agency, plus or minus any balance adjustments, compared to cash received by the utility net of fees paid and/or percentages of recoveries retained by the collection agency. In addition, since there are differences in regulatory requirements for collections in Pennsylvania versus New York, the Audit Staff proposed that the Company report and track collection performance by state jurisdiction. The Company was able to provide collection performance by state when requested, but it did not track this information for its own use.

<u>Follow-Up Finding and Conclusion No. IX-1</u> – NFGDC currently tracks collection agency performance by state jurisdiction and has developed a collection agency performance report which tracks the net amounts collected by each agency.

Three collection agencies are used for each segment (i.e., primes, seconds, and thirds). The net collections performance is tracked and evaluated for the Pennsylvania jurisdiction. Collection agency commission rates are negotiated in the contract with each agency (i.e., the commission rates for Primes, Seconds and Thirds are 14-16%, 20%, and 30%, respectively). One poor performing collection agency was eliminated in 2014. Collection agencies are compared month to month; improvement is tracked month to month. A collection agency performance report will also be included in the new Customer Information System which is estimated to be implemented by July 2015. Dunning letters are used prior to an account being turned over to a collection agency (the outside vendor that performs billing also sends out the dunning letters, charging a fee per letter, not a commission based on the dollar amount). By tracking the net collection performance of each agency by state jurisdiction, the Company can now:

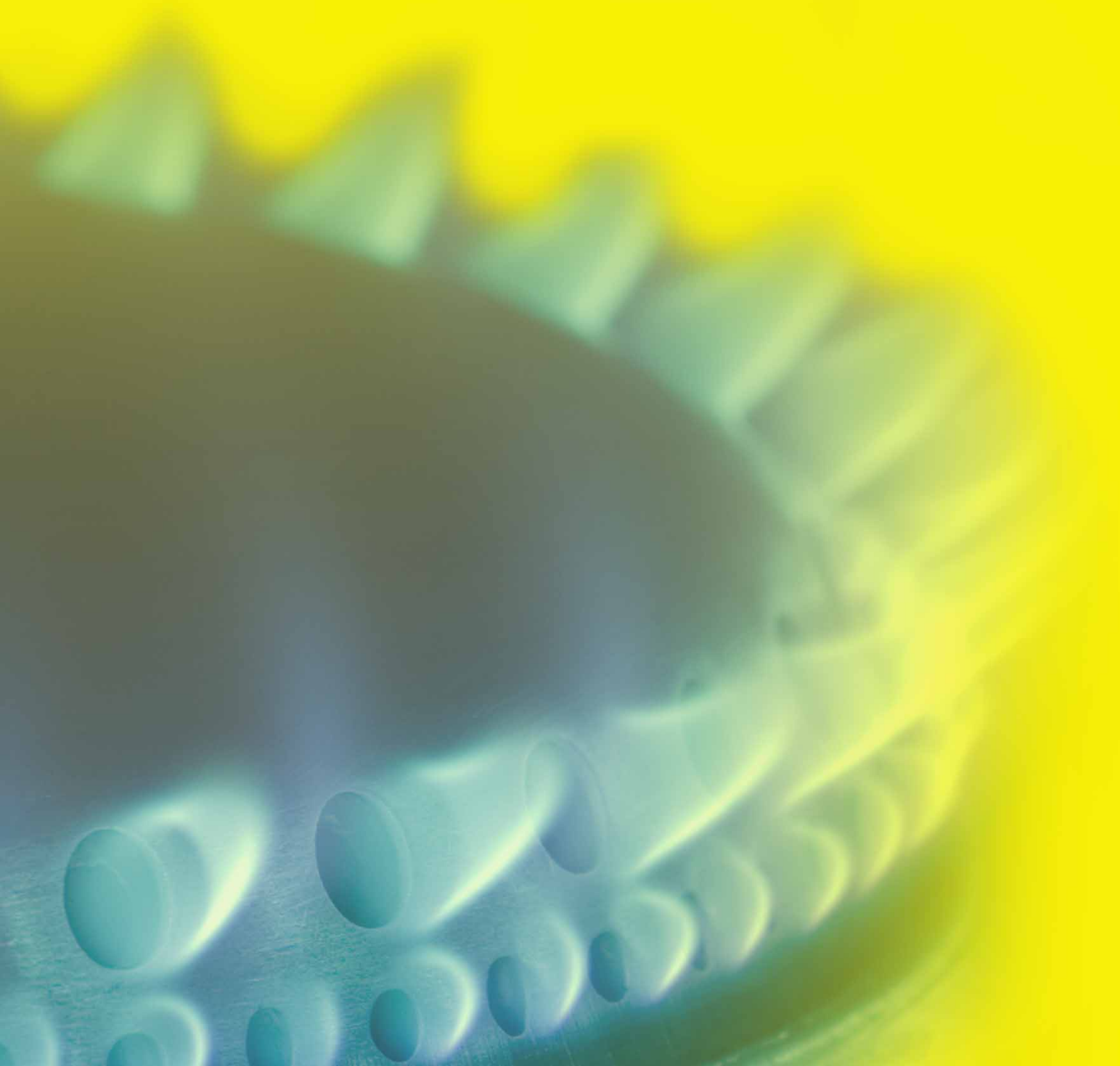
- Identify collection performance by state jurisdiction.
- Identify the strong performing agencies for benchmarking and terminate the services of poor performing agencies.

Staff's Follow-up Recommendation – None.

X. ACKNOWLEDGEMENTS

We wish to express our appreciation for the cooperation and assistance given to us during the course of this Management Efficiency Investigation by the officers and staff of National Fuel Gas Distribution Corporation and its affiliates.

This audit was conducted by Bryan Borres and Eric McKeever of the Management Audit Staff of the Bureau of Audits.



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