FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. FA19-6-000

July 15, 2020

National Fuel Gas Supply Corporation
Attention: Ms. Sarah J. Mugel
Vice President and General Counsel
6363 Main Street
Williamsville, New York 14221

Dear Ms. Mugel:

1. The Division of Audits and Accounting (DAA) within the Office of Enforcement (OE) of the Federal Energy Regulatory Commission (Commission) has completed an audit of National Fuel Gas Supply Corporation (National Fuel). The audit covered the period January 1, 2015 through December 31, 2018.

2. The audit evaluated National Fuel's compliance with: (1) its FERC NGA Gas Tariff; (2) the accounting requirements of the Uniform System of Accounts Prescribed for Natural Gas Companies under 18 C.F.R. Part 201; and (3) the reporting requirements of the FERC Form No. 2, Annual Report, under 18 C.F.R. § 260.1. The enclosed audit report contains five (5) findings of noncompliance and 19 recommendations that require National Fuel to take corrective action.

3. On June 25, 2020, you notified DAA that National Fuel does not intend to contest the five (5) findings of noncompliance and corresponding recommendations. A copy of your verbatim response is included as an appendix to this report. I hereby approve the audit report.

4. National Fuel should submit its implementation plan to comply with the recommendations within 30 days of this letter order. National Fuel should make quarterly submissions to DAA describing the progress made to comply with the recommendations, including the completion date for each corrective action. As directed by the audit report, these submissions should be made no later than 30 days after the end of each calendar quarter, beginning with the first quarter after this audit report is issued, and continuing until all the corrective actions are completed.

5. The Commission delegated the authority to act on this matter to the Director of OE under 18 C.F.R. § 375.311. This letter order constitutes final agency action. National Fuel may file a request for rehearing of this letter order with the Commission within 30 days of the date of this order under 18 C.F.R. § 385.713.

6. This letter order is without prejudice to the Commission's right to require hereafter any adjustments it may consider proper from additional information that may come to its attention. In addition, any instance of non-compliance not addressed herein or that may occur in the future may also be subject to investigation and appropriate remedies.

7. I appreciate the courtesies extended to the auditors. If you have any questions, please contact Mr. Steven D. Hunt, Director and Chief Accountant, Division of Audits and Accounting at (202) 502-6084.

Sincerely,

Larry R. Parkinson

Larry R. Parkinson
Director
Office of Enforcement

Enclosure

Federal Energy Regulatory Commission
Office of Enforcement
Division of Audits and Accounting

AUDIT REPORT

Audit of National Fuel Gas Supply Corporation's Compliance with:

- Accounting Requirements for Natural Gas Companies in 18 C.F.R. Part 201;
- FERC Form No. 2 Reporting Requirements for Natural Gas Companies in 18 C.F.R. Part 260.1; and
- Select Tariff Provisions in National Fuel Gas Supply Corporation's Tariff.

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I. Executive Summary

A. Overview

The Division of Audits and Accounting (DAA) within the Office of Enforcement of the Federal Energy Regulatory Commission (Commission) has completed an audit of National Fuel Gas Supply Corporation (National Fuel). The audit evaluated National Fuel's compliance with: (1) accounting requirements of the Uniform System of Accounts Prescribed for Natural Gas Companies under 18 C.F.R. Part 201; (2) reporting requirements of the FERC Form No. 2 under 18 C.F.R. § 260.1; and (3) select provisions of National Fuel's FERC NGA Gas Tariff (Tariff). The audit covered the period January 1, 2015 to December 31, 2018.

B. National Fuel Gas Supply Corporation

National Fuel is a corporation organized and existing under the laws of the Commonwealth of Pennsylvania with its principal place of business located in Williamsville, New York. National Fuel is a wholly owned subsidiary of National Fuel Gas Company. National Fuel Gas Company is a diversified energy company with $6.2 billion in assets distributed among five wholly owned subsidiary operating segments: Exploration and Production (Seneca Resources Company, LLC), Pipeline and Storage (National Fuel and Empire Pipeline, Inc.), Gathering (National Fuel Gas Midstream Company, LLC), Utility (National Fuel Gas Distribution Corporation), and Energy Marketing (National Fuel Resources, Inc.). National Fuel and Empire Pipeline, Inc. (Empire) are regulated as interstate gas pipeline companies by the Commission.

National Fuel owns and operates about 2,400 miles of Commission-regulated interstate natural gas pipeline facilities located in New York and Pennsylvania, where it provides transportation services to local distribution companies and other customers. National Fuel also provides storage services through 28 wholly owned underground natural gas storage fields, and three jointly owned underground storage fields.

Empire, an affiliated Commission-jurisdictional interstate gas pipeline, started operations in 1993 and owns about 266 miles of pipeline facilities. Empire generally transports natural gas from various receipt points in southern New York and at the New York-Pennsylvania border to local distribution companies, end-users, and other interstate pipelines in Western and Central New York and Canada.

C. Summary of Compliance Findings

Audit staff identified five areas of noncompliance, which are summarized below. Section IV of this report contains a detailed discussion of the audit findings.

1. *Allowance for Funds Used During Construction (AFUDC)* – National Fuel did not correctly derive the average daily short-term debt component of its AFUDC rate calculation, as it only considered a portion of the short-term debt borrowed in the month such debt was incurred. National Fuel also incorrectly applied the annual AFUDC rate it calculated to the period March through February of each year, rather than January through December, as specified in the Commission's regulations. As a result, the AFUDC rates calculated and used exceeded the maximum annual AFUDC rates allowed by the Commission in years when short-term debt was outstanding for the entire year. For those years, this resulted in an over-accrual of AFUDC, which overstated gas plant in service and associated amounts for depreciation and accumulated deferred income taxes.

2. *Accounting for Nonoperating and Operating Expenses* – National Fuel improperly accounted for certain nonoperating expenses in operating expense accounts, including costs for charitable contributions, penalties, and lobbying activities. National Fuel also improperly capitalized membership dues and lobbying expenses as a cost of construction. This accounting treatment resulted in overstating operating expenses and gas plant in service, which could impact future cost recoveries from customers, absent other procedures and controls.

3. *Valuation Method Use for System Gas Activities* – National Fuel improperly valued certain system gas activities at 90 percent of the Cash-Out Index Price, rather than 100 percent of the Cash-Out Index. As a result, National Fuel understated the balances in Account 117.4, Gas Owed to System Gas, and various operating expense accounts used to record system gas activities under the fixed asset method. National Fuel also improperly calculated the October 2018 production Monthly Index Price, which resulted in it using a higher index price and overpaying a non-affiliated shipper when cashing out its imbalance.

4. *Accounting for Fuel and Lost and Unaccounted for Gas* – National Fuel improperly recorded amounts for lost and unaccounted for gas (LAUF) and gas used for underground storage compressor stations in a transmission expense account rather than in production and gas storage expense accounts. Additionally, National Fuel recorded the cost of gas purchased to replace system gas encroachments in the incorrect production gas supply

expense account. National Fuel's improper account classifications reduced the transparency of these gas activities reported in the FERC Form No. 2.

5. *Accounting for Shipper Imbalances and Cash Outs* – National Fuel improperly netted shipper imbalance payables and receivables in Account 174, Miscellaneous Current and Accrued Assets. National Fuel also improperly netted imbalance cash-out settlement losses and gains in Account 495, Other Gas Revenues and Account 182.3, Other Regulatory Assets. National Fuel's netting reduced the transparency of these gas activities reported in the FERC Form No. 2.

D. Summary of Recommendations

Audit staff's recommendations to remedy this report's findings are summarized below. Section IV contains detailed recommendations for each finding. National Fuel will need to implement corrective actions to address each recommendation:

Allowance for Funds Used During Construction

1. Revise accounting policies and procedures to ensure it includes construction work in progress (CWIP), equity, and debt balances in its AFUDC rate calculations in accordance with the requirements of Gas Plant Instruction (GPI) No. 3(17).

2. Provide training to relevant staff on the revised AFUDC rate calculation procedures and develop a training program that supports the provision of periodic training in this area, as needed.

3. Based on the calculations, in periods that the AFUDC rate used exceeded the maximum rate allowed pursuant to GPI No. 3(17), submit proposed accounting entries and supporting documentation to DAA that reflects corrections to remove over-accrued AFUDC balances from plant and associated accounts, such as accumulated depreciation, deferred taxes, and depreciation expense, in National Fuel's books and records. Submit entries and documentation within 60 days from the issuance of this audit report.

4. Revise gas plant in service and other account balances impacted by over-accrual of AFUDC after receiving DAA's assessment of the proposed accounting entries. Restate and footnote the balances reported in the FERC Form No. 2 in the current and comparative years of the report, as necessary to reflect and disclose the revisions.

Accounting for Nonoperating and Operating Expenses

5. Strengthen accounting procedures and controls to ensure it properly records operating and nonoperating expenses consistent with Commission accounting instructions, including intercompany cost allocations.

6. Train employees responsible for account coding and assignment to ensure proper classification upon initial entry into the accounting system.

7. Reclassify all nonoperating expense activities (e.g., donations, penalties, lobbying) from operating to nonoperating expense accounts for the current year. Additionally, reclassify all operating and nonoperating expense activities capitalized during the audit period and to the present to the appropriate operating or nonoperating expense accounts. Make appropriate adjustments to National Fuel's plant accounts and to the depreciation, amortization, tax and other accounts impacted by the reclassification of such previously capitalized nonoperating expenses. Provide proposed adjusting entries and supporting documentation for accounting reclassification to DAA for review within 30 days of issuance of this audit report. Also provide a summary of the steps taken to perform the review and to make the accounting determinations.

8. After receiving from DAA the results from its review of the proposed accounting entries and supporting documentation, adjust the comparative financial statements and include footnote disclosures to explain changes in the presentation of nonoperating costs and affiliate transactions in National Fuel's next FERC Form No. 2.

Valuation Method Used for System Gas Activities

9. Revise accounting policies and procedures to ensure it values system gas at the current market price consistent with its Tariff and the fixed asset method of accounting.

10. Make necessary adjustments to remove any undervaluation of encroachments on system gas for each affected account for the current year. Submit calculations and accounting entries supporting any adjustments made for audit staff's review. Provide proposed entries and documentation for account revaluations to DAA for review within 30 days of issuance of this audit report.

11. After receiving from DAA the results from its review of proposed accounting entries and supporting documentation, adjust the comparative

financial statements and include footnote disclosures to explain changes in the valuation of system gas in National Fuel's next FERC Form No. 2.

Accounting for Fuel and Lost and Unaccounted for Gas

12. Revise its accounting policies and procedures for these gas activities to ensure consistency with Commission accounting instructions.

13. Communicate and provide necessary training for affected personnel, as needed, on these revised policies and procedures.

14. Reclassify all amounts associated with these system gas activities to the correct accounts for the current year. Submit a copy of the accounting entries and supporting documentation to DAA for review within 30 days of issuance of this audit report.

15. Include a footnote disclosure to explain changes in the presentation of imbalances in its next annual FERC Form No. 2 filing.

Accounting for Shipper Imbalances and Cash Outs

16. Revise its accounting policies and procedures for imbalances and cash-outs to ensure consistency with Commission requirements.

17. Communicate and provide necessary training for affected personnel, as needed, on updated policies and procedures.

18. Reclassify amounts associated with imbalances payables and receivables and gains and losses to the correct accounts for the current year. Submit a copy of the accounting entries and supporting documentation to DAA for review within 30 days of issuance of this audit report.

19. Include a footnote disclosure to explain changes in the presentation of imbalances in National Fuel's next annual FERC Form No. 2 filing.

E. Compliance and Implementation of Recommendations

Audit staff further recommends National Fuel submit to DAA for review:

- Plans for implementing audit staff's recommendations within 30 days of the issuance of this report;

- Quarterly reports describing National Fuel's progress in completing corrective actions for each recommendation. National Fuel should submit these nonpublic quarterly reports no later than 30 days after the end of each calendar quarter, beginning with the first quarter after the issuance of this report, and continuing each quarter until National Fuel completes the recommended corrective actions; and

- Copies of written policies and procedures developed or updated in response to this report's recommendations; copies of accounting entries made to correct errors and deficiencies; and other information supporting the corrective actions made. National Fuel should submit these entries and documents for audit staff's review in the first nonpublic quarterly report after it completes them.

II. Background

A. National Fuel's Rates and Services

National Fuel engages in the gathering, transportation, and storage of natural gas subject to the Commission's jurisdiction under the Natural Gas Act (NGA).[1] It offers these services at fixed rates under its Tariff. Its Tariff also provides National Fuel the ability to charge a negotiated rate for service under any rate schedule. National Fuel's Tariff also contains other rate mechanisms, including: Transportation and Storage Retainage and Electric Power Cost Rate (EPCR) Adjustment; Pipeline Safety and Greenhouse Gas Cost Adjustment; Annual Charge Adjustment Clause; Pass-Through of Fixed Take-or-Pay Costs Surcharge; and Transportation and Storage Costs Adjustment.

On October 31, 2011, National Fuel filed an NGA section 4 general rate case with the Commission, in Docket No. RP12-88-000. On May 22, 2012, National Fuel filed a Stipulation and Agreement (2012 Settlement) to resolve, or establish procedures for the resolution of, all issues in the section 4 general rate proceeding. Pursuant to the 2012 Settlement, National Fuel replaced fixed fuel retainage factors for its transportation and storage services with retainage factors that are subject to a tracking mechanism; this provides for the revision of retainage factors annually using a true-up mechanism. The 2012 Settlement also established periodic EPCR adjustments for the operation of compressor stations primarily powered by electric motors. The 2012 Settlement established a single system-wide, postage-stamp firm transportation rate and required National Fuel to file an NGA section 4 rate case no later than January 1, 2016. The Commission approved the 2012 Settlement on August 6, 2012.[2]

On September 29, 2015, National Fuel filed an uncontested "Supplemental Stipulation and Agreement" (the 2015 Settlement) and associated *pro forma* tariff records, to be effective November 1, 2015. The 2015 Settlement was the result of negotiations between National Fuel, its shippers, interested state commissions, and consumer advocates. National Fuel filed the 2015 Settlement in lieu of an NGA section 4 general rate case. The Commission approved the 2015 Settlement on November 13, 2015.[3] In the 2015 Settlement, National Fuel provided an immediate two percent reduction in its base reservation, capacity, demand, and deliverability rates, effective November 1, 2015, and another two percent reduction effective on November 1, 2016. National Fuel also implemented a new "Pipeline Safety and Greenhouse Gas Cost

[1] 15 U.S.C. §§ 717-717w (2018).

[2] *See National Fuel Gas Supply Corp.*, 140 FERC ¶ 61,114 (2012).

[3] *See National Fuel Gas Supply Corp.*, 153 FERC ¶ 61,170 (2015).

Adjustment Mechanism" to recover costs associated with new legislation and regulatory requirements adopted after August 14, 2015. The 2015 Settlement had a "comeback provision" which required National Fuel to file its next NGA section 4 general rate case on or before December 31, 2019.

On July 18, 2018, the Commission issued Order No. 849.[4] Pursuant to this order, National Fuel committed to file an NGA section 4 general rate case by July 31, 2019, five months earlier than the deadline established in the 2015 Settlement. On July 31, 2019, National Fuel filed proposed new rates in Docket No. RP19-1426-000 (2019 Rate Case). National Fuel and the parties agreed to a "black box" settlement (Settlement) which was filed with the Commission on March 13, 2020. Under the Settlement, no party may make a rate filing for new rates to be effective before February 1, 2024, except that National Fuel may file for increases in corporate income tax rates. The Settlement also provides for new depreciation rates and a new Pipeline Safety and Greenhouse Gas Cost Adjustment Mechanism. If no case has been filed, National Fuel must file for rates to be effective February 1, 2025. The Settlement was approved as filed by the Commission on June 1, 2020.[5]

B. National Fuel's System

National Fuel's 2,400-mile reticulated gas pipeline system extends from southwestern Pennsylvania to the New York-Canadian border, and eastward to Ellisburg and Leidy, PA, with facilities in or near regions overlying Marcellus and Utica Shale gas production. National Fuel's pipeline network provides access to Appalachian shale gas, and interconnects with other pipelines that access markets in Canada and the Mid-Atlantic region of the United States. National Fuel's wholly owned 28 underground natural gas storage fields are situated at various locations along the pipeline in New York and Pennsylvania, and the 3 partially owned storage fields are located in Pennsylvania.

National Fuel's natural gas firm transportation capacity is subject to change as the market conditions associated with transportation paths and receipt/delivery points change. In 2017, National Fuel had firm transportation service agreements and leases for 3,157 MDth of capacity per day. Of this capacity, National Fuel's affiliates held 44 percent, while non-affiliates held 56 percent. National Fuel's underground natural gas storage facilities have a combined firm capacity of 68,042 MDth, with 55 percent located in New

[4] *Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate,* Order No. 849, 164 FERC ¶ 61,031 (2018), *reh'g denied*, Order No. 849-A, 167 FERC ¶ 61,051 (2019).

[5] *National Fuel Gas Supply Corp.*, 171 FERC ¶ 61,176 (2020).

York, and 45 percent in Pennsylvania. Storage capacity on National Fuel's system is held by affiliates and non-affiliates.

C. Implementation of the 2017 Tax Cuts and Jobs Act

On July 18, 2018, the Commission issued Order No. 849, providing procedures and regulations regarding the effect of reduced corporate income taxes on natural gas pipelines and their rates.[6] Notably, Order No. 849 required interstate natural gas pipelines to file FERC Form No. 501-G, an abbreviated cost and revenue study designed to illustrate the effect of reduced corporate tax rates, which FERC could use to determine whether the pipeline's rates may be unjust and unreasonable under the NGA.

Order No. 849 provided four options to account for reduced corporate income tax rates. National Fuel elected Option 3 and submitted an addendum to the FERC Form No. 501-G, on December 6, 2018, reflecting what it considered more representative data for ratemaking purposes.[7] National Fuel indicated its Return on Equity (ROE) was below the threshold of ROEs that have triggered NGA section 5 proceedings in the past, and is either below or not greatly in excess of calculated ROEs of proxy group companies included in recent NGA section 4 rate case filings. National Fuel committed to file an NGA section 4 general rate case no later than July 31, 2019. Upon filing, the Commission terminated the company's FERC Form No. 501-G proceeding.[8]

As of December 31, 2017, National Fuel booked adjusting entries to reflect the impact of the 2017 Tax Cuts and Jobs Act. The estimated reduction in deferred income taxes of $118.2 million was recorded as a decrease to Account 182.3, Other Regulatory Assets, of $2.9 million and an increase to Account 254, Other Regulatory Liabilities, of

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[6] In December 2017, President Trump signed the Tax Cuts and Jobs Act into law, which reduced the marginal federal corporate income tax rate from 35 to 21 percent. In response, on March 15, 2018, the Commission issued a Notice of Proposed Rulemaking proposing to require interstate natural gas pipelines to file new FERC Form No. 501-G. *See Interstate and Intrastate Natural Gas Pipelines; Rate Changes Relating to Federal Income Tax Rate*, Order No. 849, 164 FERC ¶ 61,031 (2018), *reh'g denied*, Order No. 849-A, 167 FERC ¶ 61,051 (2019) (adding 18 C.F.R. § 260.402).

[7] Option 3 is: file a statement explaining why no adjustment to rates is needed. *See National Fuel Gas Supply Corporation*, National Fuel's FERC Form No. 501-G, submitted December 6, 2018 in Docket No. RP19-429-000.

[8] *See National Fuel Gas Supply Corp.*, "Order Accepting and Suspending Tariff Records, Subject to Refund, Establishing Hearing Procedures, and Terminating FERC Form No. 501-G Proceeding," 168 FERC ¶ 61,140 (2019) (issued in both Docket Nos. RP19-429-000 and RP19-1426-000).

$115.3 million. The company had not begun amortizing the regulatory asset or liability because the methods and timelines for returning over collected tax revenues to the ratepayers had not yet been determined. The Settlement filed by National Fuel in Docket No. RP19-1426-000 addresses the amortization of such tax revenues.

III. Introduction

A. Objectives

The audit evaluated National Fuel's compliance with: (1) the accounting requirements of the Uniform System of Accounts Prescribed for Natural Gas Companies, under 18 C.F.R. Part 201; (2) the reporting requirements of the FERC Form No. 2, under 18 C.F.R. § 260.1; and (3) select provisions of National Fuel's Tariff. The audit covered the period January 1, 2015 to December 31, 2018.

B. Scope and Methodology

Audit staff performed the following actions to facilitate testing and evaluate National Fuel's compliance with Commission requirements relevant to this audit:

Audit Planning, Processes, and Administration

- *Review of Public Information* – Reviewed publicly available materials to understand National Fuel's corporate structure and relationship with its parent and affiliates. Reviewed Commission filings and orders to understand National Fuel's effective and historical cost of service rates, including traditional recourse, non-traditional, and negotiated rates, and other rate mechanisms. This review also covered significant regulatory actions, such as certificate projects, tariff modifications, accounting filings and decisions, and other key matters. Reviewed National Fuel's Tariff provisions, rate schedules, and service agreements; FERC Form No. 2s and 3-Qs; Security and Exchange Commission Forms 10-K and 10-Q; National Fuel's main website; and informational postings available on its electronic bulletin board, in news media, and on other internet websites.

- *Conferred with Commission Staff* – Conferred with other Commission offices to ensure that audit report findings were written consistent with Commission precedent and policy.

- *Regulatory Standards and Criteria* – Identified regulatory requirements and criteria to evaluate National Fuel's compliance with each audit objective. These regulatory requirements included applicable accounting and reporting requirements, tariff provisions, rate filings and orders, and other relevant regulatory orders involving National Fuel or other companies.

- *Opening and Closing Conferences* – Held an opening conference to explain the audit process, address questions, clarify basic information, and discuss data requests and site visit procedures subsequent to commencing the audit. At the conclusion of audit field work, held a closing conference to discuss audit report findings and recommendations, and next steps in the audit process.

- *FERC Data Requests* – Issued formal data requests and emails to obtain information and documents not publicly available. Also, used data requests to clarify National Fuel's policies, procedures, accounting and reporting practices, and other information with which to evaluate compliance.

- *Conference Calls* – Held regular teleconferences with National Fuel on administrative and technical matters. These discussions clarified the company's policies and procedures, enhanced audit staff's understanding of information received in data responses, and addressed administrative matters relating to data requests, site visits, and audit progression.

- *Site Visits* – Conducted two site visits to National Fuel's headquarters in Williamsville, NY. Each site visit provided the opportunity to obtain information relevant to the audit's objectives and risks.

    - *Initial Site Visit* – Discussed corporate structure and affiliate relations, pipeline operations and related tariff provisions, accounting and billing systems, historical and effective rates, and surcharges and tracking mechanisms. Observed and discussed business practices, procedures, and internal control structures for various accounting and reporting matters. Interviewed employees and managers responsible for performing tasks within the audit's scope.

    - *Second Site Visit* – Obtained a detailed understanding of National Fuel's key accounting and operational practices and procedures. Audit staff's interviews and discussions focused on AFUDC rates, affiliate transactions, nonoperating expenses, leases, income taxes, refund obligations, rate adjustments, tracking mechanisms, and FERC Form No. 2 accounting and reporting with a focus on system gas.

- *Board of Directors Meeting Minutes and Audit Committee Meeting Minutes* – Reviewed corporate Board of Directors meeting minutes and Audit Committee meeting minutes to identify audit risks relating to the audit scope.

- *Audit Testing* – Audited National Fuel's compliance with the Commission's accounting and financial reporting requirements, document retention requirements, and select tariff provisions by evaluating, on a sample basis, evidence supporting the amounts reported in the FERC Form No. 2 and the activities and documents supporting select operational requirements of National Fuel's Tariff.

FERC NGA Gas Tariff Requirements

Commission Filings and Orders

- *Natural Gas Rate Filings and Orders* – Reviewed National Fuel's filings and related Commission orders establishing rates, including recourse rates, negotiated rates, and tracking mechanisms effective in the audit period. Evaluated whether National Fuel filed negotiated and non-conforming agreements with the Commission and identified them in its Tariff.

Pipeline Transportation and Storage Rates and Shipper Billings

- *Tariff Rate Schedules* – Reviewed National Fuel's Tariff to understand National Fuel's transportation and storage rates and services.

- *Shipper Billings* – Sampled customer invoices for firm and interruptible services to determine whether National Fuel charged appropriate rates.

Surcharges and Tracking Rate Mechanisms

- *Tariff Provisions* – Reviewed National Fuel's Tariff to identify and understand surcharges and tracking rate mechanisms.

- *Transportation and Storage Retainage and EPCR Adjustment* – Selected National Fuel's 2017 Fuel Retainage filing for compliance testing. Interviewed key personnel that prepare the annual filing to understand the calculation, schedules, and inputs used to derive a volumetric percentage rate. Verified the method was applied consistently for filings made in other years of the audit period. Traced volumes used to support the rate to source documents.

Reservation Charge Crediting Practices

- *Commission Policy* – Reviewed the Commission's policy statement on mechanisms for the recovery of modernization costs, issued in Docket No. PL15-1-000, particularly the section relating to reservation charge crediting.[9]

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[9] *See Cost Recovery Mechanisms for Modernization of Natural Gas Facilities,* 151 FERC ¶ 61,047, at P 116 (stating that "a pipeline's compliance with its tariff to

Evaluated National Fuel's compliance with the Commission's reservation charge crediting policy, which the Commission directed audit staff to scrutinize during audits as part of that policy.[10]

- *Tariff Language* – Reviewed National Fuel's Tariff for *force majeure* and *non-force majeure* event definitions and applicable reservation charge crediting provisions for consistency with Commission policy statement.

- *System Events* – Assessed National Fuel's classification of *force majeure*, maintenance, capacity constraint, and other events. Evaluated whether National Fuel timely posted these events on its electronic bulletin board and described the event to shippers in critical or noncritical notices. Examined instances when National Fuel interrupted or redirected firm service for a shipper or could not schedule a shipper nomination because of the declaration of a *force majeure* or *non-force majeure* event. Reviewed a sample of invoices to determine whether National Fuel credited reservation charges to affected shippers for their reduction in nominated or scheduled capacity volumes.

<u>Uniform System of Accounts Requirements</u>

- *Accounting Processes, Procedures, and Controls* – Evaluated National Fuel's financial accounting processes, procedures, and controls used to comply with the accounting requirements under 18 C.F.R. Part 201. Interviewed National Fuel employees to understand accounting policies, procedures, and practices, and to determine how such employees seek to ensure that the structure and operation of National Fuel's accounting system information aligns with Commission requirements.

- *Chart of Accounts* – Reviewed National Fuel's chart of accounts to understand the account coding used to record journal entry transactions and to determine whether the conversion of its internal accounts to the Commission's Uniform System of Accounts resulted in proper mapping.

- *Application of Uniform System of Accounts* – Analyzed National Fuel's interpretation and use of select balance sheet and income statement accounts

implement a modernization cost tracker may be subject to scrutiny through a Commission audit"), *clarification denied,* 152 FERC ¶ 61,046 (2015).

[10] *See Natural Gas Supply Association*, 135 FERC ¶ 61,055, at P 28 (urging pipelines to come into compliance with the Commission's reservation charge crediting policy and directing audit staff to examine pipelines' tariffs and practices during audits for such compliance), *reh'g denied,* 137 FERC ¶ 61,051 (2011).

for consistency with Commission accounting requirements. For example, audit staff evaluated expense accounts to determine whether National Fuel properly classified and accounted for operating and nonoperating expenses.

- *Significant Accounting Matters* – Tested select balance sheet and income statement accounts to determine whether the nature of the transactions recorded in them complied with Commission regulations under 18 C.F.R. Part 201. Examples of significant accounting matters examined included:

  - *Cash Management Program* – Evaluated National Fuel's implementation and operation of its corporate cash management program. Compared the terms of National Fuel's cash management agreement to the actual operations of its cash management program for consistent application of the agreement's terms. Tested accounts associated with the cash management program to evaluate consistency with Commission accounting requirements. Evaluated National Fuel's inclusion of short-term and long-term cash management borrowings in its AFUDC rate calculation.

  - *Allowance for Funds Used During Construction* – Tested National Fuel's calculation of debt and equity AFUDC rates. This included the components of the capital structure used to determine the capital ratio, the method used to calculate the monthly accrual, and accounting for AFUDC. More specifically, this included evaluating the support for the balances and cost rates used to derive the debt and equity components of the AFUDC rate calculation, and the application of short-term debt as the first source of financing. Besides these tests, reviewed Commission decisions involving the maximum AFUDC rate, rate orders involving National Fuel's AFUDC rate calculation, and past audit reports issued to National Fuel.

  - *Construction Work in Progress* – Evaluated construction activities for projects to test whether the costs qualified as a component of construction under the Commission's Uniform System of Accounts. Examined National Fuel's process for placing capital projects into service, designation of property retirement units, and account coding.

  - *Capital Improvements and General Maintenance* – Evaluated National Fuel's capital improvement and general maintenance justification and approval process. Obtained an overview of the project life cycle, which encompassed each phase from creation to completion. Examined the assignment of costs, such as labor, overhead, and materials and supplies to project work orders, and related accounting decisions.

- *Depreciation Rates and Expense* – Verified the application of Commission-approved depreciation rates and tested the calculation of depreciation expense. Evaluated depreciation related accounts and traced amounts reported in the FERC Form No. 2 to the general ledger. Reviewed disclosures in the FERC Form No. 2 filings for unusual activities or adjustments in depreciation accounts.

- *Asset Retirement Obligations* (*ARO*) – Reviewed ARO activities and disclosures in National Fuel's FERC Form No. 2 filings. Evaluated National Fuel's implementation of ARO accounting, including current recognition of asset retirement costs, accretion and depreciation expense, and regulatory assets and liabilities.

- *Affiliate Transactions* – Reviewed affiliate transactions to determine whether National Fuel recorded revenues and costs, for goods and services it provided or received, in the correct account based on the nature of the transaction. Reviewed parent company charges to assess whether costs were collected, allocated, and recorded properly.

- *Operating and Nonoperating Expenses* – Examined operating or above-the-line accounts to determine whether National Fuel included nonoperating or below-the-line expenses (e.g., lobbying, charitable contributions, entertainment, penalties, and fines) in operating expense accounts. Also, examined whether National Fuel recorded operating expenses in the appropriate operating expense accounts.

- *Income Taxes and Tax Allocation Agreements* – Evaluated National Fuel's consolidated income tax allocation sharing agreement and the tax payment structure between National Fuel and National Fuel Gas Company, including the methodology used to allocate tax benefits/burdens. Reviewed the adjustments made to the regulatory asset and liability accounts in response to the Tax Cuts and Jobs Acts of 2017 and related FERC Form No. 501-G filing required in response to the Commission's Order No. 849.

- *System Gas Accounting* – Reviewed system gas activities to evaluate whether National Fuel properly accounted for encroachments upon system gas, imbalances, gas losses, and other activities in accordance with the fixed asset method of accounting outlined in Order No. 581.[11]

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[11] *Revisions to Uniform System of Accounts, Forms, Statements, and Reporting*

Reviewed National Fuel's method of valuing system gas, such as shipper imbalance cash-outs, compressor fuel, and lost and unaccounted for gas, for consistency with National Fuel's Tariff.

FERC Form No. 2 Reporting Requirements

- *Reporting Processes, Procedures, and Controls* – Reviewed and evaluated processes, procedures, and controls for complying with Commission financial reporting requirements in 18 C.F.R. § 260.1. Interviewed employees that performed financial reporting and management oversight to assess their understanding of the processes, procedures, and controls.

- *FERC Form No. 2 Preparation and Filing* – Examined procedures for preparing, reviewing, and filing National Fuel's FERC Form No. 2 filings to assess completeness and accuracy of financial statements and schedules.

- *Variance Analysis* – Performed variance analyses of balance sheet and income statement accounts reported in the FERC Form No. 2 filings for the audit period. Analyzed anomalies to identify potential accounting and reporting concerns.

- *Notes to Financial Statements* – Reviewed the notes to financial statements to understand significant accounting policies and events, and to identify potential accounting and reporting concerns. Compared certain notes in the financial statements to specific schedules for consistency in reported information.

- *Accuracy and Completeness in Reporting* – Sampled FERC Form No. 2 accounts and reviewed supporting documentation to evaluate whether National Fuel accurately reported activity and balances. As part of the review, audit staff traced account balances in the FERC Form No. 2 to National Fuel's general ledger and reviewed individual schedules and related detail pages to test for consistent and complete reporting under the FERC Form No. 2 instructions. Some of the more significant examples of testing included:

  - *Gas Account Natural Gas Volumes* (*Page 520*) – Compared volumes reported on Page 520 of the FERC Form No. 2 to National Fuel's

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Requirements for Natural Gas Companies, Order No. 581, 72 FERC ¶ 61,301 (1995) (Order No. 581), *order on reh'g*, Order No. 581-A, 74 FERC ¶ 61,223, *order granting clarification*, 75 FERC ¶ 61,106 (1996); *see also Uniform System of Accounts, Forms, Statements, and Reporting Requirements for Natural Gas Companies,* Notice of Correction, 118 FERC ¶ 61,245 (2007) (making correction to Order No. 581).

operational data for 2017. Specifically, selected one month and traced volumes to source documents for gas received, delivered, used, and lost.

- *Non-Traditional Rate Treatment Afforded to New Projects* – Tested the accuracy and completeness of amounts reported on Page 217 of the FERC Form No. 2. Evaluated whether National Fuel maintained separate and identifiable accounts for costs and revenues associated with incremental rate projects as required by the Commission.

- *Other Select Accounts and Schedules* – Tested select FERC Form No. 2 schedules and accounts to evaluate whether National Fuel reported accurate and complete information consistent with the form's instructions. Traced account balances in the financial statements of the FERC Form No. 2 to supporting schedules and National Fuel's general ledger. Some of the specific accounts and schedules evaluated include: Account 117.4, Gas Owed to System Gas (Page 220); Account 401, Operation Expense, and Account 402, Maintenance Expense (Pages 317-325); and Account 495, Other Gas Revenues (Page 308). Also identified and assessed material changes that impacted operating, maintenance, and administrative and general expense accounts.

IV. Findings and Recommendations

1. Allowance for Funds Used During Construction

National Fuel did not correctly derive the average daily short-term debt component of its AFUDC rate calculation, as it only considered a portion of the short-term debt borrowed in the month such debt was incurred. National Fuel also incorrectly applied the annual AFUDC rate it calculated to the period March through February of each year, rather than January through December, as specified in the Commission's regulations. As a result, the AFUDC rates calculated and used exceeded the maximum annual AFUDC rates allowed by the Commission in years when short-term debt was outstanding for the entire year. For those years, this resulted in an over-accrual of AFUDC, which overstated gas plant in service and associated amounts for depreciation and accumulated deferred income taxes.

Pertinent Guidance

- 18 C.F.R. Part 201, GPI No. 3, Components of Construction Cost, states in subpart 3(17), in relevant part:

> "Allowance for funds used during construction" includes the net cost for the period of construction of borrowed funds used for construction purposes and a reasonable rate on other funds when so used, not to exceed without prior approval of the Commission allowances computed in accordance with the formula prescribed in paragraph (a) [of this subpart]. . . .
>
> . . . .
>
> (b) The rates shall be determined annually. The balances for long-term debt, preferred stock and common equity shall be the actual book balances as of the end of the prior year. The cost rates for long-term debt and preferred stock shall be the weighted average cost determined in the manner indicated in subpart D of part 154 of the Commission's Regulations under the Natural Gas Act. The cost rate for common equity shall be the rate granted common equity in the last rate proceeding before the ratemaking body having primary rate jurisdiction. If such cost rate is not available, the average rate actually earned during the preceding three years shall be used. The short-term debt balances and related cost and the average balance for construction work in progress shall be estimated

> for the current year with appropriate adjustments as actual data becomes available.

- In Order No. 561, the Commission's predecessor, the Federal Power Commission, stated:

> [T]he balances of long-term debt, preferred stock, and common equity for use in the formula for the current year will be the balances in such accounts at the end of the prior year; the cost rates for long-term debt and preferred stock will be the effective weighted average cost of such capital. The average short-term debt balances and related cost and the average construction work in progress balance will be estimated for the current year.[12]

Background

Audit staff evaluated National Fuel's accounting practices for the capitalization of AFUDC on CWIP. Specifically, audit staff tested National Fuel's AFUDC accrual calculation, including National Fuel's determination of the debt and equity rates used in determining the AFUDC rate applied to CWIP. Audit staff's evaluations identified that National Fuel's AFUDC accrual calculation departed from the Commission's prescribed formula for capitalizing AFUDC in ways that caused National Fuel's AFUDC rate to exceed the maximum rate allowed in Order Nos. 561 and 561-A and GPI No. 3(17).

Audit staff's review determined that National Fuel calculated the short-term debt component of its AFUDC rate calculation based on a 12-month average ratio of construction expenditures to total cash needs as defined by National Fuel's internal methodology.[13] Audit staff determined that this methodology did not adhere to the

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[12] *Amendments to Uniform System of Accounts for Public Utilities and Licensees and for Natural Gas Companies* (*Classes A, B, C and D*) *to Provide for the Determination of Rate for Computing the Allowance for Funds Used During Construction and Revisions of Certain Schedule Pages of FPC Reports*, Order No. 561, 57 FPC 608, at 610-611 (1977) (Order No. 561), *reh'g denied*, Order 561-A, 59 FPC 1340 (1977) (Order No. 561-A), *order on clarification,* 2 FERC ¶ 61,050 (1978).

[13] National Fuel's methodology represented a ratio of construction expenditures divided by construction expenditures + long-term debt repayments + short-term debt repayments + any net increase in working capital, multiplied by the short-term debt added during the month, but only if there was an increase in short-term debt during the month, with short-term debt in all other months reflected as zero.

Commission's requirements. National Fuel's methodology only considered short-term debt in the month it was issued and traced that debt to construction expenditures incurred in that same month. This was contrary to GPI No. 3(17), Order Nos. 561 and 561-A, and Commission orders applying these requirements.[14] To determine the short-term debt balance, National Fuel should have used a daily average of all its outstanding short-term debt for the previous year, with consideration of any adjustments for actuals in the current year the AFUDC rate was applied. National Fuel's methodology resulted in an understatement of short-term debt used in the AFUDC rate calculation in 2015 and 2019.

Audit staff also determined that National Fuel calculated its AFUDC rates annually in February and applied that rate to construction costs incurred for the twelve months from March to February of the following year. As such, when National Fuel applied the AFUDC rate in January and February, the balances for the long-term financing components (i.e., common equity, preferred stock, and long-term debt) were the book balances from two years ago rather than year-end of the prior year. This was inconsistent with the Commission's regulations, which require that "[t]he balances for long-term debt, preferred stock and common equity be the actual book balances as of the end of the prior year."[15]

Audit staff requested that National Fuel recalculate the AFUDC rates for prior years to reflect the corrected short-term debt balances and year-end balances for the common equity, long-term debt, and preferred stock components. Audit staff reviewed these calculations, concluding that National Fuel's annual AFUDC rates exceeded the maximum rate allowed in GPI No. 3(17) when it had short-term debt outstanding for the entire year. This resulted in an over-accrual of AFUDC, which overstated gas plant in service and associated amounts for depreciation and accumulated deferred income taxes in those years. Correcting these deficiencies will ensure National Fuel's AFUDC rate does not exceed the maximum rate in any year on future capital projects.

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[14] *Otter Tail Power Co.*, 119 FERC ¶ 61,217 at P 12 ("as the Commission stated in both Order Nos. 561 and 561-A, … it was not the intent of the rule to try to trace the source of funds used for various corporate purposes").

[15] 18 C.F.R. Part 201, GPI No. 3(17)(b) (2019).

Recommendations

We recommend that National Fuel:

1. Revise accounting policies and procedures to ensure it includes CWIP, equity, and debt balances in its AFUDC rate calculations in accordance with the requirements of GPI No. 3(17).

2. Provide training to relevant staff on the revised AFUDC rate calculation procedures and develop a training program that supports the provision of periodic training in this area, as needed.

3. Based on the calculations, in periods that the AFUDC rate used exceeded the maximum rate allowed pursuant to GPI No. 3(17), submit proposed accounting entries and supporting documentation to DAA that reflects corrections to remove over-accrued AFUDC balances from plant and associated accounts, such as accumulated depreciation, deferred taxes, and depreciation expense, in National Fuel's books and records. Submit entries and documentation within 60 days from the issuance of this audit report.

4. Revise gas plant in service and other account balances impacted by over-accrual of AFUDC after receiving DAA's assessment of the proposed accounting entries. Restate and footnote the balances reported in the FERC Form No. 2 in the current and comparative years of the report, as necessary to reflect and disclose the revisions.

2. Accounting for Nonoperating and Operating Expenses

National Fuel improperly accounted for certain nonoperating expenses in operating expense accounts, including costs for charitable contributions, penalties, and lobbying activities. National Fuel also improperly capitalized membership dues and lobbying expenses as a cost of construction. This accounting treatment resulted in overstating operating expenses and gas plant in service, which could impact future cost recoveries from customers, absent other procedures and controls.

<u>Pertinent Guidance</u>

- 18 C.F.R. Part 201, General Instruction No. 14, Transactions with Associated Companies, states in part:

  > Transactions with associated companies shall be recorded in the appropriate accounts for transactions of the same nature. Nothing herein contained, however, shall be construed as restraining the utility from subdividing accounts for the purpose of recording separately transactions with associated companies.

- Commission regulations in 18 C.F.R. Part 201 provide the following specific account instructions for recording nonoperating expenses:

  > SPECIAL INSTRUCTIONS
  >
  > *Accounts 426.1, 426.2, 426.3, 426.4, and 426.5*
  >
  > These accounts shall include miscellaneous expense items which are nonoperating in nature, but which are properly deductible before determining total income before interest charges.
  >
  > NOTE: The classification of expenses as nonoperating and their inclusion in these accounts is for accounting purposes. It does not preclude Commission consideration of proof to the contrary for ratemaking or other purposes.

  The specific accounts themselves state as follows:

  - o Account 426.1, Donations: "This account shall include all payments or donations for charitable, social or community welfare purposes."

- Account 426.3, Penalties: "This account shall include payments by the company for penalties or fines for violation of any regulatory statutes by the company or its officials."

- Account 426.4, Expenditures for Certain Civic, Political and Related Activities: "This account shall include expenditures for the purpose of influencing public opinion with respect to the election or appointment of public officials, referenda, legislation, or ordinances (either with respect to the possible adoption of new referenda, legislation or ordinances or repeal or modification of existing referenda, legislation or ordinances) or approval, modification, or revocation of franchises; or for the purpose of influencing the decisions of public officials, but shall not include such expenditures which are directly related to appearances before regulatory or other governmental bodies in connection with the reporting utility's existing or proposed operations."

- Commission regulations in 18 C.F.R. Part 201 provide specific account instructions for recording membership dues. Account 930.2, Miscellaneous General Expenses, states in part:

> This account shall include the cost of labor and expenses incurred in connection with the general management of the utility not provided for elsewhere.
>
> ITEMS
>
> *Labor:*
> 1. Miscellaneous labor not elsewhere provided for[.]
> *Expenses:*
> 2. Industry Association dues for company memberships.

- Commission regulations in 18 C.F.R. Part 201 are also prescriptive as to what can be included in construction costs and, ultimately, gas plant in service:

  - Account 107, Construction Work In Progress—Gas, states in part: "This account shall include the total of the balances of work orders for gas plant in process of construction."

- GPI No. 3, Components of Construction Cost, states in part:

  The cost of construction properly includable in the gas plant accounts shall include, where applicable, the direct and overhead costs as listed and defined hereunder: (1) “Contract work”. . . . (2) “Labor”. . . . (3) “Materials and supplies”. . . . (4) “Transportation”. . . . (5) “Special machine service”. . . . (6) “Shop service”. . . . (7) “Protection”. . . . (8) “Injuries and damages”. . . . (9) “Privileges and permits”. . . . (10) “Rents”. . . . (11) “Engineering and supervision”. . . . (12) “General administration capitalized”. . . . (13) “Engineering services”. . . . (14) “Insurance”. . . . (15) “Law expenditures”. . . . (16) “Taxes”. . . . (17) “Allowance for funds used during construction”. . . . (18) “Earnings and expenses during construction”. . . . (19) “Training costs”. . . . (20) “Line pack gas”. . . . (21) LNG “heel”. . . . (22) “Studies”. . . . (23) “Asset retirement costs”.

Background

Audit staff evaluated National Fuel’s compliance with the Commission’s accounting regulations regarding the recognition and classification of nonoperating and operating expenses. Audit staff identified weaknesses in National Fuel’s accounting procedures and internal controls, which resulted in account misclassifications of four expense types – charitable contributions, penalties, lobbying expenses, and membership dues – as discussed below.

Charitable Contributions and Donations

During the audit period, National Fuel did not report any amounts for charitable contributions and donations in its FERC Form No. 2 filings using the account prescribed for such costs: Account 426.1, Donations. However, audit staff’s examination identified invoices that were clearly designated as charitable contributions and donations by the originating affiliate company and allocated to National Fuel. Some examples of charitable contributions allocated to National Fuel included donations to the Theatre of Youth and Big Brothers Big Sisters.

National Fuel recorded these charitable contributions and donations in Account 930.2, Miscellaneous General Expenses. National Fuel should have recorded these transactions in Account 426.1, a nonoperating expense account, rather than Account 930.2, an operating expense account. The text to Account 426.1 states that “[t]his account shall include all payments or donations for charitable, social or community welfare purposes.” Additionally, 18 C.F.R. Part 201, General Instruction No. 14 requires companies to record transactions with affiliates in the appropriate account based on the nature of the original expense. Costs billed to National Fuel by an affiliate must be classified in the appropriate accounts, as if National Fuel had directly incurred those costs. For these reasons, National Fuel should classify charitable contributions and donations in Account 426.1.

Environmental Penalties

Audit staff analyzed National Fuel's accounting for judgments, fines, penalties, and settlement obligations incurred or recognized in the audit period. Audit staff found that National Fuel paid civil penalties to the Pennsylvania Department of Environmental Protection for (1) installing a triethylene glycol dehydrator without approval, and (2) discharging industrial waste and pollutants into waters of the Commonwealth without a permit. The company recorded both penalties in Account 107, Construction Work in Progress—Gas. National Fuel explained that it considered both penalties to be additional costs of construction and therefore recorded these costs in Account 107. National Fuel also paid a penalty assessed by the New York State Department of Environmental Conservation for disposing of a regulated waste product without a permit, which it incorrectly recorded in Account 859, Other Expenses.

In accordance with the Commission's accounting regulations, National Fuel should have recorded these penalties in Account 426.3, Fines and Penalties, rather than Accounts 107 or 859. Upon audit staff's discovery, National Fuel acknowledged that the accounting for these penalties was an oversight by the staff that prepared the requests for payment.

Membership Dues and Lobbying Activities

National Fuel was a member of several industry trade associations that performed lobbying functions on behalf of their members. Each year, the trade associations billed National Fuel's parent company for annual dues, which the parent paid and then allocated the expense to its two pipelines, National Fuel and Empire. In reviewing these invoices, audit staff identified a portion of the annual dues paid to Consumer Energy Alliance and to the Business Council of New York State Incorporated that represented amounts supporting lobbying activities. National Fuel recorded the expenses, including both the lobbing and non-lobbying portions, in Account 107 and Account 930.2.

In accordance with the Commission's accounting regulations, National Fuel should have recorded the lobbying portion of the annual dues in Account 426.4, rather than in Accounts 107 and 930.2. Besides the lobbying portion, National Fuel improperly recorded its non-lobbying membership dues paid to Consumer Energy Alliance in Account 107. National Fuel explained that it recorded the membership dues in Account 107 because the work performed by Consumer Energy Alliance was important in advancing the Northern Access and Empire North construction projects.[16] While this may be the case, company membership dues, less any associated lobbying portion, are appropriately recorded in Account 930.2 rather than Account 107. Furthermore, by its express terms, Account 107 is used to capture construction costs for gas plant under construction, not membership dues in industry advocacy organizations.

In summary, classifying operating and nonoperating expenses according to Commission accounting instructions will ensure costs are properly classified for ratemaking purposes. Procedural and control weaknesses resulting in account misclassifications are a concern because nonoperating expenses are generally not factored into the development and evaluation of rates. Considering this, it is imperative National Fuel implement effective procedures and controls to ensure account classifications of nonoperating expenses are consistent with Commission accounting requirements.

Recommendations

We recommend that National Fuel:

5. Strengthen accounting procedures and controls to ensure it properly records operating and nonoperating expenses consistent with Commission accounting instructions, including intercompany cost allocations.

6. Train employees responsible for account coding and assignment to ensure proper classification upon initial entry into the accounting system.

7. Reclassify all nonoperating expense activities (e.g., donations, penalties, lobbying) from operating to nonoperating expense accounts for the current year. Additionally, reclassify all operating and nonoperating expense activities capitalized during the audit period and to the present to the appropriate operating or nonoperating expense accounts. Make appropriate adjustments to National Fuel's plant accounts and to the depreciation, amortization, tax and other accounts impacted by the reclassification of such previously capitalized nonoperating expenses. Provide proposed adjusting entries and supporting documentation for accounting reclassification to DAA for review within 30 days of issuance of this audit report. Also provide a summary of the steps taken to perform the review and to make the accounting determinations.

[16] Consumer Energy Alliance purports to advocate for sensible energy policies for all consumers (https://consumerenergyalliance.org/about/).

8. After receiving from DAA the results from its review of the proposed accounting entries and supporting documentation, adjust the comparative financial statements and include footnote disclosures to explain changes in the presentation of nonoperating costs and affiliate transactions in National Fuel's next FERC Form No. 2.

3. Valuation Method Used for System Gas Activities

National Fuel improperly valued certain system gas activities at 90 percent of the Cash-Out Index Price, rather than 100 percent of the Cash-Out Index. As a result, National Fuel understated the balances in Account 117.4, Gas Owed to System Gas, and various operating expense accounts used to record system gas activities under the fixed asset method. National Fuel also improperly calculated the October 2018 production Monthly Index Price, which resulted in it using a higher index price and overpaying a non-affiliated shipper when cashing out its imbalance.

Pertinent Guidance

- Order No. 581 states in part:

> [T]he Commission will require all pipelines to value encroachments at current market price as originally proposed. For purposes of valuing the encroachments, current market price means the delivered spot price of gas as published in a recognized industry journal. The publication used must be the same one identified in the pipeline's tariff for use in its cash-out provision, if it has one.[17]
> ….
> For cashed-out imbalances in which the pipeline has delivered less than the shipper has tendered into the pipeline, the gain (or loss) will be the difference between the cash-out price paid by the pipeline and the current price of volumes recorded in Account 117.4.[18]
> ….
> [T]he Commission agrees that under the fixed asset model, losses of system gas should be priced at the same rate used to price withdrawals in the month in which the loss is recognized (i.e. the current market price of gas available to the utility).[19]
> ….
> Pipelines recognizing revenue and purchased gas expense for shipper provided gas should value such amounts at current

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[17] Order No. 581, 72 FERC ¶ 61,301, FERC Stats. & Regs. ¶ 31,026, at 31,459.

[18] *Id*.

[19] *Id*. at 31,459-60.

> market value. Values to be assigned to fuel consumed in compressor stations or used for other operational purposes should be similarly determined. . . .[T]he Commission believes that the current market value must be determined by reference to the delivered spot price of gas as published in a recognized industry journal. The publication used must be the same one identified in the pipeline's tariff for use in its cash-out provision, if it has one.[20]

- National Fuel's Tariff provides cash-out procedures, which describe the valuation methodology. Specifically:

> 14.9 Cash-Out of Imbalances
>
> If a Shipper which has elected (or been deemed to elect) to resolve imbalances via cash-out has a Cumulative Monthly Imbalance in excess of one MITL, that Shipper's entire Cumulative Monthly Imbalance shall be cashed-out as described in this Section 14.9.
>
>> (a) Clearing of negative imbalances. Should such imbalance be negative, the imbalance shall be subject to Negative Imbalance Cash-Out. . . .
>>
>> Transporter shall post the Negative Imbalance Cash-Out Price for each month on its web site. The Negative Imbalance Cash-Out Price shall be equal to one hundred ten percent (110%) of the following index (the "Index"), computed for the month in which the imbalance arose:
>>
>>> The simple average of:
>>>
>>> (1) the Dominion South Point Index, which shall be computed by taking the average of spot gas prices delivered to the Dominion South Point price point, from every issue of Natural Gas Intelligence's Weekly Gas Price Index ("NGIW") that contains a table of spot prices for the applicable month;

[20] *Id*. at 31,462.

> (2) the Tennessee Zone 4 Index, which shall be computed by taking the average of spot gas prices delivered to the TGP Zone 4-200 Leg price point, from every issue of NGIW that contains a table of spot prices for the applicable month; and
>
> (3) the Transco Leidy Index, which shall be computed by taking the average of spot gas prices delivered to the Transco-Leidy Line price point, from every issue of NGIW that contains a table of spot prices for the applicable month.
>
> (b) Clearing of Positive Imbalances. Should such imbalance be positive, the imbalance shall be subject to Positive Imbalance Cash-Out.
>
> The Positive Imbalance Cash-Out Price shall be equal to ninety percent (90%) of the Index as defined in Section 14.9(a) hereof.[21]

Background

System gas represents the maximum designated gas volumes needed for no-notice transportation service and recoverable base gas volumes. Under Commission regulations, the investment in and the use of system gas, which is recorded in Accounts 117.1, Gas Stored-Base Gas, and 117.2, System Balancing Gas, should be accounted for using either the fixed-asset method of accounting or the inventory method of accounting, whichever method a company chooses. National Fuel confirmed it uses the fixed asset method of accounting for its system gas. National Fuel stated there were no changes in its application of the fixed asset method since its last rate case. Under this method, the amounts in Accounts 117.1 and 117.2 are fixed, and not affected by valuation changes. Rather, encroachments upon System Gas are recorded in Account 117.4, Gas Owed to System Gas. This is a contra asset account and represents the current market value of the volume of system gas encroached upon. Besides this account, there are numerous expense accounts used to record system gas activities affected by valuation.

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[21] National Fuel Gas Supply Corporation, FERC NGA Gas Tariff, Fifth Revised Volume No.1, GT&C Section 14.9, Cash-Out of Imbalances.

System Gas Valuation

Audit staff examined National Fuel's accounting for gas activities to determine whether the company valued them consistently with its Tariff. Part 7, Section 14.9 of National Fuel's Tariff, entitled "Cash-Out of Imbalances," with an effective date of October 8, 2017, required National Fuel to use the spot prices listed in Natural Gas Intelligence's Weekly Gas Price Index for the Dominion South Point Index, Tennessee Zone 4 Index, and Transco Leidy Index to determine the monthly average price to be used to value imbalance activities (Cash-Out Index Price). The averages of these weekly indexes are themselves averaged to determine the monthly Cash-Out Index Price for valuing imbalance activities under National Fuel's Tariff.

Audit staff reviewed National Fuel's accounting for system gas activities and found that the company improperly used 90 percent of its current month's Cash-Out Index Price to value these activities. These activities included: (1) encroachments, revaluation, and cash-out gains and losses; (2) compressor fuel and LAUF; and (3) replacement of system gas. National Fuel should have used 100 percent of the Cash-Out Index Price (i.e., the current market value) to value all of these activities except for replacement cost of system gas, which should be valued at the actual price paid. National Fuel's Tariff Section 14.9 specifies the use of the Cash-Out Index Price as representative of the current market price. Order No. 581 also provides that fuel consumed in compressor stations, losses of system gas, and gas stored in underground reservoirs should be priced at the current market price.

The table below provides the approximate difference in account balances when using 90 percent and 100 percent of the Cash-Out Index Price as of December 31, 2018:

Account No/Description	90%	100%	Difference
117.4, Gas owed to system gas	460,753	512,520	-51,767
854, Gas for Compressor Station Fuel	11,869,934	13,188,816	-1,318,882
810, Gas Used for Compressor Station Fuel-Credit	-11,869,934	-13,188,816	1,318,882
808.1, Gas Withdrawn from Storage-Debit	2,923,542	3,248,380	-324,838
(Less) 808.2 Gas Delivered to Storage-Credit	-3,121,671	-3,468,523	346,852
806, Exchange Gas	361,107	401,230	40,123

Index Price Calculation

Audit staff also tested the calculation of the index price and discovered that National Fuel did not include the Dominion South Point Index in the Cash-Out Index Price calculation for the October 2018 Production/November 2018 Accounting month as required by its Tariff. Audit staff compared the difference between the averages of the index prices National Fuel used (i.e., excluding the Dominion South Point Index prices) and the monthly averages of all three indexes specified in its Tariff, for the period the Dominion South Point Index prices were not included in National Fuel's Cash-Out Index Price calculation. The two-index average price exceeded the three-index average price for the October 2018 Production/November 2018 Accounting month by $.0789 per dekatherm. Consequently, National Fuel overpaid one customer by $3,323 for the purchase of the customer's long imbalance. The company acknowledged that it made a data entry error omitting the Dominion South Point Index.

Recommendations

We recommend that National Fuel:

9. Revise accounting policies and procedures to ensure it values system gas at the current market price consistent with its Tariff and the fixed asset method of accounting.

10. Make necessary adjustments to remove any undervaluation of encroachments on system gas for each affected account for the current year. Submit calculations and accounting entries supporting any adjustments made for audit staff's review. Provide proposed entries and documentation for account revaluations to DAA for review within 30 days of issuance of this audit report.

11. After receiving from DAA the results from its review of proposed accounting entries and supporting documentation, adjust the comparative financial statements and include footnote disclosures to explain changes in the valuation of system gas in National Fuel's next FERC Form No. 2.

4. Accounting for Fuel and Lost and Unaccounted for Gas

National Fuel improperly recorded amounts for LAUF and gas used for underground storage compressor stations in a transmission expense account rather than in production and gas storage expense accounts. Additionally, National Fuel recorded the cost of gas purchased to replace system gas encroachments in the incorrect production gas supply expense account. National Fuel's improper account classifications reduced the transparency of these gas activities reported in the FERC Form No. 2.

Pertinent Guidance

- 18 C.F.R. Part 201, Account 801, Natural Gas Field Line Purchases, states in part:

> A. This account shall include the cost, at point of receipt by the utility, of natural gas purchased in gas fields or production areas at points along gathering lines, and at points along the utility's transmission lines within field or production areas, exclusive of purchases at outlets of gasoline plants includible in account 802, where facilities of the vendor or others are used in bringing the gas from the well head to the point of entry into the utility's natural gas system.

- 18 C.F.R. Part 201, Account 803, Natural Gas Transmission Line Purchases, states in part:

> A. This account shall include the cost, at point of receipt by the utility, of natural gas purchased at points along the utility's transmission lines not within gas fields or production areas, excluding purchases at the outlets of products extraction plants includible in Account 802.

- 18 C.F.R. Part 201, Account 812, Gas Used for Other Utility Operations – Credit, states in part:

> This account shall include concurrent credits for charges which are made to operating expenses or other accounts of the gas department for gas consumed from the common system supply for operating and utility purposes other than uses for which credits are includible in any of the foregoing accounts.

- 18 C.F.R. Part 201, Account 813, Other Gas Supply Expenses, states in part:

> B. Include in separate subaccounts: (1) losses on settlements of imbalance receivables and payables (See Account 174 and 242) and losses on replacement of encroachment volumes (See the Special Instructions to Accounts 117.1, 117.2 and 117.3); (2) revaluations of storage encroachments; and (3) *system gas losses not associated with storage*. Appropriate records must be maintained and readily available that include the amount of losses and associated volumes in Dth. [Emphasis added.]

- 18 C.F.R. Part 201, Account 819, Compressor Station Fuel and Power, states in part:

> A. This account shall include the cost of gas, coal, oil, or other fuel, or electricity, used for the operation of underground storage compressor stations, including applicable amounts of fuel stock expenses.
>
> B. Records shall be maintained to show the quantity of each type of fuel consumed or electricity used at each compressor station, and the cost of such fuel or power. Respective amounts of fuel stock and fuel stock expenses shall be readily available.

- 18 C.F.R. Part 201, Account 854, Gas for Compressor Station Fuel, states:

> A. This account shall include the cost of gas used for the operation of transmission compressor stations.
>
> B. Records shall be maintained to show the Dth of gas consumed at each compressor station, and the cost of such gas.

Background

Section 41 of National Fuel's Tariff identifies the components recoverable through National Fuel's fuel reimbursement mechanism, collectively referred to in the Tariff as "Fuel and Losses," as follows: (1) transportation and storage fuel, (2) company use,

(3) lost and unaccounted for gas, and (4) electric compression costs.[22] LAUF is the difference between gas purchased (gas received on a pipeline) and gas sold (gas delivered off a pipeline). There are two major categories or sources of LAUF: (1) leaks and (2) gas measurement errors. Leaks are gas escaping to the atmosphere at a given rate at an unknown location. Gas measurement is the accounting and tracking of gas received into the system and gas delivered off the system or used in operations. National Fuel explained that the basis for quantifying its LAUF is its determination of the difference between the volumes reported from all receipt, fuel and delivery meters on its system. Audit staff reviewed the accounting entries and supporting schedules for each component of National Fuel's fuel tracker. Based on this review, audit staff determined that National Fuel incorrectly accounted for LAUF and Storage Compressor Fuel expenses, treating them as transmission expenses by recording them in Account 854, Gas for Compressor Station Fuel. The accounting misclassifications, however, did not impact National Fuel's recoveries through its fuel reimbursement mechanism.

Specifically, for LAUF, National Fuel recorded the expense in Account 854, with an offsetting entry to Account 810, Gas Used for Compressor Station Fuel – Credit. According to Commission regulations, these accounts reflect the cost of gas used to operate transmission compressor stations and do not include activities associated with LAUF. National Fuel should have recorded LAUF in Account 813, Other Gas Supply Expenses, with an offsetting entry to Account 812, Gas Used for Other Utility Operations – Credit. Account 813 should include all system gas losses not associated with storage, while Account 812 provides the offset for gas consumed from the system gas supply for operating and utility purposes that are not includible in any other account. For Storage Compressor Fuel, National Fuel recorded the expense in Account 854 with an offsetting entry to Account 810. National Fuel should have recorded the expense in Account 819, Compressor Station Fuel and Power, as this account includes the cost of gas to operate underground storage compressor stations, with an offsetting entry to Account 810.

Besides these system gas activities, National Fuel incorrectly accounted for operational gas purchases that were made to replace shipper encroachments of system gas during the audit period. National Fuel recorded gas purchase expense in Account 801, Natural Gas Field Line Purchases, with an offsetting entry to Account 232, Accounts Payable. National Fuel should have recorded the expense in Account 803, Natural Gas Transmission Line Purchases, as these purchases served to facilitate operational pressures in its transmission pipeline.

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[22] National Fuel Gas Supply Corporation, FERC NGA Gas Tariff, Fifth Revised Volume No. 1, GT&C Section 41, Transportation and Storage Retainage and EPCR Adjustments.

Recording LAUF and Storage Compressor Fuel incorrectly as transmission compressor station fuel reduced the financial transparency of these activities as reported in the FERC Form No. 2s filed by National Fuel. Proper account classification is important for functionalizing costs in developing and evaluating rates.

Recommendations

We recommend that National Fuel:

12. Revise its accounting policies and procedures for these gas activities to ensure consistency with Commission accounting instructions.

13. Communicate and provide necessary training for affected personnel, as needed, on these revised policies and procedures.

14. Reclassify all amounts associated with these system gas activities to the correct accounts for the current year. Submit a copy of the accounting entries and supporting documentation to DAA for review within 30 days of issuance of this audit report.

15. Include a footnote disclosure to explain changes in the presentation of imbalances in its next annual FERC Form No. 2 filing.

5. Accounting for Shipper Imbalances and Cash-Outs

National Fuel improperly netted shipper imbalance payables and receivables in Account 174, Miscellaneous Current and Accrued Assets. National Fuel also improperly netted imbalance cash-out settlement losses and gains in Account 495, Other Gas Revenues and Account 182.3, Other Regulatory Assets. National Fuel's netting reduced the transparency of these gas activities reported in the FERC Form No. 2.

Pertinent Guidance

- 18 C.F.R. Part 201, Account 174, Miscellaneous Current and Accrued Assets, states in part:

> B. The utility is to include in a separate subaccount amounts receivable for gas in unbalanced transactions where gas is delivered to another party in exchange, load balancing, or no-notice transportation transactions. (See Account 806.) If the amount receivable is settled by other than gas, Account 495, Other Gas Revenues must be credited or Account 813, Other Gas Supply Expenses, charged for the difference between the amount of the consideration received and the recorded amount of the receivable settled. Records are to be maintained so that there is readily available for each party entering gas exchange, load balancing, or no-notice transportation transactions, the quantity and cost of gas delivered, and the amount and basis of consideration received, if other than gas.

- 18 C.F.R. Part 201, Account 242, Miscellaneous Current and Accrued Liabilities, states in part:

> B. The utility is to include in a separate subaccount amounts payable for gas in unbalanced transactions where gas is received from another party in exchange, load balancing, or no-notice transportation transactions. (See Account 806.) If the amount payable is settled by other than gas, Account 495, Other Gas Revenues, must be credited or Account 813, Other gas supply expenses, charged for the difference between the amount of the consideration paid and the recorded amount of the payable settled. Records are to be maintained so that there is readily available for each party entering gas exchange, load balancing, or no-notice transportation transactions, the quantity and cost of gas received, and the amount and basis of consideration paid if other than gas.

- 18 C.F.R. Part 201, Account 182.3, Other Regulatory Assets, states in part:

> A. This account shall include the amounts of regulatory-created assets, not includible in other accounts, resulting from the ratemaking actions of regulatory agencies. (*See* Definition No. 31.)
>
> B. The amounts included in this account are to be established by those charges which would have been included in net income, or accumulated other comprehensive income, determinations in the current period under the general requirements of the Uniform System of Accounts but for it being probable that such items will be included in a different period(s) for purposes of developing rates that the utility is authorized to charge for its utility services. . . .

- 18 C.F.R. Part 201, Account 254, Other Regulatory Liabilities, states in part:

> A. This account shall include the amounts of regulatory liabilities, not includible in other accounts, imposed on the utility by the ratemaking actions of regulatory agencies. (*See* Definition No. 30.)
>
> B. The amounts included in this account are to be established by those credits which would have been included in net income, or accumulated other comprehensive income, determinations in the current period under the general requirements of the Uniform System of Accounts but for it being probable that: Such items will be included in a different period(s) for purposes of developing the rates that the utility is authorized to charge for its utility services; or refunds to customers, not provided for in other accounts, will be required. . . .

- 18 C.F.R. Part 201, Account 495, Other Gas Revenues, states in part:

> This account includes revenues derived from gas operations not includible in any of the foregoing accounts.
>
> ITEMS
>
> . . . .
>
> 8. Include in a separate subaccount, gains on settlements of imbalance receivables and payables (See Accounts 174 and 242) and

> gains on replacement of encroachment volumes (See Account 117.4). Records must be maintained and readily available to support the gains included in this account.
>
> 9. Include in a separate subaccount revenues from penalties earned pursuant to tariff provisions, including penalties associated with cash-out settlements.

- 18 C.F.R. Part 201, Account 813, Other Gas Supply Expenses, states:

> A. This account shall include the cost of labor, materials used and expenses incurred in connection with gas supply functions not provided for in any of the above accounts, including, research and development expenses. These accounts are to be used by both transmission and distribution companies to account for natural gas storage expenses. If the utility operates both transmission and distribution systems, subaccounts shall be maintained classifying the expenses to the transmission or distribution function.
>
> B. Include in separate subaccounts: (1) *losses on settlements of imbalance receivables and payables* (See Account 174 and 242) and losses on replacement of encroachment volumes (See the Special Instructions to Accounts 117.1, 117.2 and 117.3); (2) revaluations of storage encroachments; and (3) system gas losses not associated with storage. Appropriate records must be maintained and readily available that include the amount of losses and associated volumes in Dth. [Emphasis added.]

Background

National Fuel adopted the fixed asset method of accounting to record its system gas activities, pursuant to the Commission's Order No. 581.[23] Under the fixed asset method, volumetric and valuation changes are recorded as encroachments upon system gas, which result from various activities including shipper imbalances. Based on analysis of the company's accounting, National Fuel did not properly record imbalances and the settlement of imbalances through its cash-out mechanism in the required accounts.

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[23] *See* Order No. 581, 72 FERC ¶ 61,301 (1995), *order on reh'g*, Order No. 581-A, 74 FERC ¶ 61,223, *order granting clarification*, 75 FERC ¶ 61,106 (1996); *see also Uniform System of Accounts, Forms, Statements, and Reporting Requirements for Natural Gas Companies,* Notice of Correction, 118 FERC ¶ 61,245 (2007) (making correction to Order No. 581).

Imbalance Recognition

An imbalance occurs when there are differences in the quantities of natural gas received by the pipeline from shippers versus those physically delivered by the pipeline back to the shippers. Pursuant to Order No. 581, National Fuel, having elected to use the fixed asset method of accounting, is required to record the value of gas relating to the initial recognition of the imbalance in the month it occurs. This should be recorded in Account 806, Exchange Gas, with a contra entry in Account 174, Miscellaneous Current and Accrued Assets, or Account 242, Miscellaneous Current and Accrued Liabilities, as appropriate (i.e., depending on whether the pipeline owes, or is owed, gas). Where a shipper cashes out its imbalance in the next month, National Fuel should reverse the entry in Account 806, and make a contra entry to either Account 174 or Account 242. While these accounting transactions net to zero, National Fuel still must establish a current asset or liability for the activity until it cashes out the imbalance with the shipper.

National Fuel's accounting procedures did not fully comply with these requirements when it initially established an imbalance on its books. Specifically, National Fuel recorded the value of its gas imbalances in Account 806 with the contra entry for both receivables and payables in Account 174. This accounting treatment led to National Fuel recording imbalance payables in a receivable account. National Fuel should refrain from netting imbalances payables with receivables in Account 174, and record imbalance payables in Account 242.

Imbalance Cash-Out Settlement

National Fuel settles imbalances with shippers in accordance with section 14 of the general terms and conditions of its Tariff, which governs its cash-out mechanism.[24] Under the requirements of this section, all imbalances between monthly receipts and deliveries remaining at the time of final resolution are cashed out at the applicable Index Price specified in National Fuel's Tariff. Section 14 obligates National Fuel to refund cash-out revenues received in excess of costs incurred, using the procedures in Section 15 of the Tariff.[25] Order No. 581 also provides accounting guidance for gains and losses on imbalance transactions:

> The Commission will modify its proposed accounting for gains and losses on imbalance transaction[s] in instances in which a pipeline's tariff requires that such gains and losses be passed along to

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[24] National Fuel Gas Supply Corporation, FERC NGA Gas Tariff, Fifth Revised Volume No. 1, GT&C Section 14 (1.0.0), Allocations and Imbalances.

[25] *Id.*; *see* Section 15 (0.0.0), Refund of Cash-Out Revenues.

> customers. Rather than initially recording a gain or loss (in Account 495 and Account 813, respectively) and separately deferring the gain or loss as a regulatory asset or liability (by charging Account 407.3, Regulatory Debits, or crediting Account 407.4, Regulatory Credits, respectively), the Commission will require pipelines to record the gain or loss on imbalances directly in Account 254, Other Regulatory Liabilities, or Account 182.3, Other Regulatory Assets, as appropriate consistent with Order No. 552.[26]

National Fuel's accounting procedures did not fully comply with these requirements for recognizing losses on imbalance transactions. When National Fuel cashed-out imbalances, it recorded cash-out gains and losses in Account 495, Other Gas Revenues, and deferred amounts in Account 182.3, Other Regulatory Assets. However, National Fuel should only record gains on settlements of imbalance receivables and payables in Account 495, with the deferred amount of the gain in Account 254, Other Regulatory Liabilities. Losses on settlements of imbalance receivables and payables should be recorded in Account 813, Other Gas Supply Expenses, with the deferred amount of the loss in Account 182.3.

In conclusion, Order No. 581 established accounting for system gas activities to provide transparency to the financial statement users. Improper netting of system gas activities deprives the users of this information and the transparency afforded to them by the Commission's regulations.

Recommendations

We recommend that National Fuel:

16. Revise its accounting policies and procedures for imbalances and cash-outs to ensure consistency with Commission requirements.

17. Communicate and provide necessary training for affected personnel, as needed, on updated policies and procedures.

18. Reclassify amounts associated with imbalances payables and receivables and gains and losses to the correct accounts for the current year. Submit a copy of the accounting entries and supporting documentation to DAA for review within 30 days of issuance of this audit report.

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[26] Order No. 581, FERC Stats. & Regs. ¶ 31,026 at 31,464-65 (footnote omitted).

19. Include a footnote disclosure to explain changes in the presentation of imbalances in National Fuel's next annual FERC Form No. 2 filing.

V. National Fuel's Response to Audit Report

national fuel

June 25, 2020

Mr. Steven Hunt
Acting Director and Chief Accountant
Division of Audits and Accounting
Federal Energy Regulatory Commission
888 First Street, N.E., Rm 51-37
Washington, D.C. 20426

Re: National Fuel Gas Supply Corporation
Docket No. FA19-6-000

Dear Mr. Hunt,

By the letter dated June 10, 2020, the Division of Audits and Accounting ("DAA") within the Office of Enforcement of the Federal Energy Regulatory Commission ("Commission") notified National Fuel Gas Supply Corporation ("National Fuel") that it had completed an audit of National Fuel. The audit evaluated National Fuel's compliance with: (1) select portions of its FERC Gas Tariff, (2) the Uniform System of Accounts for natural gas companies under 18 C.F.R. Part 201; and (3) FERC Form 2 reporting requirements under 18 C.F.R. § 260.1. The audit covered January 1, 2015 to December 31, 2018.

The DAA completed a draft audit report dated June 10, 2020 ("draft audit report") outlining the findings of the audit, as well as making certain recommendations. National Fuel was requested to respond and state whether it agrees or disagrees with those findings and recommendations. DAA identified five findings of noncompliance and made 19 corrective action recommendations.

As discussed in more detail below, National Fuel does not contest Findings 1-5 and agrees to implement Recommendations 1 through 19. It is also important to note that consolidated financial statements reported under generally accepted accounting principles (GAAP), including as contained in National Fuel's periodic filings with the U.S. Securities and Exchange Commission, through its parent, National Fuel Gas Company, were not affected by the classification issues noted by the audit staff as these line items are not reported separately as they are in FERC reporting. The separate GAAP financial statements previously issued by National Fuel Gas Company will not change.

As specified in the draft audit report, National Fuel will submit its non-public implementation plan with respect to such recommendations to DAA within 30 days after the final audit report is issued. In addition, National Fuel will submit nonpublic quarterly reports to audit staff describing its progress in completing each of these recommendations, along with copies of any written policies and procedures developed in response to the

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recommendations, which will be submitted for review in the first non-public quarterly submission after it completed them.

The recommendations contained in the draft audit report are set forth below, followed by National Fuel's responses:

Finding 1 - Allowance for Funds Used During Construction (AFUDC)

Recommendation 1. Revise accounting policies and procedures to ensure it includes CWIP, equity, and debt balances in its AFUDC rate calculations in accordance with the requirements of GPI No. 3(17).

National Fuel's Response: National Fuel agrees to update its accounting policies and procedures to ensure it includes CWIP, equity and debt balances in its AFUDC rate calculations in accordance with the requirements of GPI No. 3(17). National Fuel and FERC Audit Staff have reviewed National Fuel's methodology for calculating AFUDC in resolution of this issue. National Fuel will update its policies and procedures in accordance with the requirements of GPI No. 3(17) using the agreed upon methodology specified in Supplement to Data Request 3, DR2053-3 dated June 6, 2019.

Recommendation 2. Provide training to relevant staff on the revised AFUDC rate calculation procedures and develop a training program that supports the provision of periodic training in this area, as needed.

National Fuel's Response: National Fuel agrees to provide training to relevant staff on the revised AFUDC rate calculation procedures and will develop a training program that supports the provision of periodic training in this area, as needed.

Recommendation 3. Based on the calculations, in periods that the AFUDC rate used exceeded the maximum rate allowed pursuant to GPI No. 3(17), submit proposed accounting entries and supporting documentation to DAA that reflects corrections to remove over-accrued AFUDC balances from plant and associated accounts, such as accumulated depreciation, deferred taxes, and depreciation expense, in National Fuel's books and records. Submit entries and documentation within 60 days from the issuance of this audit report.

National Fuel's Response: Within 60 days from the issuance of the Audit Report, National Fuel agrees to submit proposed accounting entries and supporting documentation to DAA that reflects corrections to remove over-accrued AFUDC balances from plant and associated accounts, consistent with the methodology noted in response to Recommendation 1, including accumulated depreciation, deferred taxes, and depreciation expense, in National Fuel's books and records.

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Recommendation 4. Revise gas plant in service and other account balances impacted by over-accrual of AFUDC after receiving DAA's assessment of the proposed accounting entries. Restate and footnote the balances reported in the FERC Form No. 2 in the current and comparative years of the report, as necessary to reflect and disclose the revisions.

National Fuel's Response: National Fuel agrees to revise gas plant in service and other account balances impacted by over-accrual of AFUDC after receiving DAA's assessment of the proposed accounting entries. National Fuel will restate and footnote the balances reported in FERC Form 2 in the current and comparative years of the report, as necessary to reflect and disclose the revisions.

Finding 2 - Accounting for Nonoperating and Operating Expenses

Recommendation 5. Strengthen accounting procedures and controls to ensure it properly records operating and nonoperating expenses consistent with Commission accounting instructions, including intercompany cost allocations.

National Fuel's Response: National Fuel agrees to strengthen accounting procedures and controls to ensure it properly records operating and nonoperating expenses consistent with Commission accounting instructions, including intercompany cost allocations.

Recommendation 6. Train employees responsible for account coding and assignment to ensure proper classification upon initial entry into the accounting system.

National Fuel's Response: National Fuel agrees to train employees responsible for account coding and assignment to ensure proper classification upon initial entry into the accounting system.

Recommendation 7. Reclassify all nonoperating expense activities (e.g., donations, penalties, lobbying) from operating to nonoperating expense accounts for the current year. Additionally, reclassify all operating and nonoperating expense activities capitalized during the audit period and to the present to the appropriate operating or nonoperating expense accounts. Make appropriate adjustments to National Fuel's plant accounts and to the depreciation, amortization, tax and other accounts impacted by the reclassification of such previously capitalized nonoperating expenses. Provide proposed adjusting entries and supporting documentation for accounting reclassification to DAA for review within 30 days of issuance of this audit report. Also provide a summary of the steps taken to perform the review and to make the accounting determinations.

National Fuel's Response: National Fuel will reclassify all nonoperating expense activities (e.g., donations, penalties, lobbying) from operating to nonoperating expense accounts for the current year. National will also reclassify all operating and nonoperating

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Division of Audits and Accounting
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expense activities capitalized during the audit period and to the present to the appropriate operating or nonoperating expense accounts. National Fuel will also make appropriate adjustments to its plant accounts and to the depreciation, amortization, tax and other accounts impacted by the reclassification of such previously capitalized nonoperating expenses. National Fuel will provide proposed adjusting entries and supporting documentation for accounting reclassification to DAA for review within 30 days of issuance of this audit report and will provide a summary of the steps taken to perform the review and to make the accounting determinations.

Recommendation 8. After receiving from DAA the results from its review of the proposed accounting entries and supporting documentation, adjust the comparative financial statements and include footnote disclosures to explain changes in the presentation of nonoperating costs and affiliate transactions in National Fuel's next FERC Form No. 2.

National Fuel's Response: After receiving from DAA the results of DAA's review of the proposed accounting entries and supporting documentation, National Fuel will adjust the comparative financial statements and include footnote disclosures to explain changes in the presentation of nonoperating costs and affiliate transactions in National Fuel's next Form No. 2.

Finding 3 - Valuation Method Used for System Gas Activities

Recommendation 9. Revise accounting policies and procedures to ensure it values system gas at the current market price consistent with its Tariff and the fixed asset method of accounting.

National Fuel's Response: National Fuel agrees to revise accounting policies and procedures to ensure it values system gas at the current market price consistent with its Tariff and the fixed asset method of accounting.

Recommendation 10. Make necessary adjustments to remove any undervaluation of encroachments on system gas for each affected account for the current year. Submit calculations and accounting entries supporting any adjustments made for audit staff's review. Provide proposed entries and documentation for account revaluations to DAA for review within 30 days of issuance of this audit report.

National Fuel's Response: National Fuel agrees to make necessary adjustments to remove any undervaluation of encroachments on system gas for each affected account for the current year. National Fuel will submit calculations and accounting entries supporting any adjustments made for audit staff's review. National Fuel will provide proposed entries and documentation for account revaluations to DAA for review within 30 days of issuance of this audit report.

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Recommendation 11. After receiving from DAA the results from its review of proposed accounting entries and supporting documentation, adjust the comparative financial statements and include footnote disclosures to explain changes in the valuation of system gas in National Fuel's next FERC Form No. 2.

National Fuel's Response: After receiving from DAA the results of DAA's review of the proposed accounting entries and supporting documentation, National Fuel will adjust the comparative financial statements and include footnote disclosures to explain changes in the valuation of system gas in National Fuel's next FERC Form 2.

Finding 4 - Accounting for Fuel and Lost and Unaccounted for Gas

Recommendation 12. Revise its accounting policies and procedures for these gas activities to ensure consistency with Commission accounting instructions.

National Fuel's Response: National Fuel agrees to revise accounting policies and procedures for these gas activities to ensure consistency with the Commission's accounting instructions.

Recommendation 13. Communicate and provide necessary training for affected personnel, as needed, on these revised policies and procedures.

National Fuel's Response: National Fuel agrees to communicate and train employees responsible, as needed on these revised policies and procedures.

Recommendation 14. Reclassify all amounts associated with these system gas activities to the correct accounts for the current year. Submit a copy of the accounting entries and supporting documentation to DAA for review within 30 days of issuance of this audit report.

National Fuel's Response: National Fuel will reclassify all amounts associated with these system gas activities to the correct accounts for the current year. National Fuel will submit a copy of the proposed entries and documentation to DAA for review within 30 days of issuance of this audit report.

Recommendation 15. Include a footnote disclosure to explain changes in the presentation of imbalances in its next annual FERC Form No. 2 filing.

National Fuel's Response: National Fuel will include a footnote disclosure in its next FERC Form 2 filing.

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Finding 5 - Accounting for Shipper Imbalances and Cash-Outs

Recommendation 16. Revise its accounting policies and procedures for imbalances and cash-outs to ensure consistency with Commission requirements.

National Fuel's Response: National Fuel agrees to revise accounting policies and procedures for imbalances and cash-outs to ensure consistency with the Commission's accounting instructions.

Recommendation 17. Communicate and provide necessary training for affected personnel, as needed, on updated policies and procedures.

National Fuel's Response: National Fuel agrees to communicate and train employees responsible, as needed on these updated policies and procedures.

Recommendation 18. Reclassify amounts associated with imbalances payables and receivables and gains and losses to the correct accounts for the current year. Submit a copy of the accounting entries and supporting documentation to DAA for review within 30 days of issuance of this audit report.

National Fuel's Response: National Fuel will reclassify amounts associated with imbalances, payables, and receivables, and gains and losses to the correct accounts for the current year. National Fuel will submit a copy of the proposed entries and documentation to DAA for review within 30 days of issuance of this audit report.

Recommendation 19. Include a footnote disclosure to explain changes in the presentation of imbalances in National Fuel's next annual FERC Form No. 2 filing.

National Fuel's Response: National Fuel will include a footnote disclosure to explain changes in the presentation of imbalances in its next FERC Form 2 filing.

National Fuel takes the compliance with all of the FERC's regulations, including compliance with the accounting provisions of the Commission's regulations, very seriously. National Fuel welcomes the opportunity to improve and enhance its compliance efforts, including continuing to foster a culture of compliance with every aspect of the FERC's rules within the company. National Fuel appreciates the time and attention the audit staff paid to all of the matters they reviewed while visiting the company and while discussing the issues reviewed in subsequent follow up conversations. National Fuel looks forward to continuing that discussion with audit staff in order to achieve the goals of compliance stated herein in a timely manner. National Fuel is a company that continuously strives to improve its performance in all areas, including in the areas of compliance and reporting and looks forward to furthering that objective with the audit staff in the coming months.

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Should the audit staff have any questions related to National Fuel's compliance with these recommendations, please contact us at the numbers below.

Respectfully submitted,

National Fuel Gas Supply Corporation

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