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NATIONAL FUEL GAS CO
Form U-1
October 09, 2001

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File No. 70-[]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM U-1
APPLICATION/DECLARATION
UNDER THE
PUBLIC UTILITY HOLDING COMPANY ACT OF 1935

NATIONAL FUEL GAS COMPANY
10 Lafayette Square
Buffalo, New York 14203

(Name of company filing this statement
and address of principal executive offices)

NATIONAL FUEL GAS COMPANY

(Name of top registered holding company parent)

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President and Chief Executive Officer
National Fuel Gas Company
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Buffalo, New York 14203

(Name and address of agent for service)

The Commission is requested to mail copies of all
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ITEM 1. DESCRIPTION OF PROPOSED TRANSACTION

National Fuel Gas Company ("National") is a registered holding company under the Public Utility Holding Company Act of 1935, as amended (the "Act"). Through its subsidiaries, National engages in a diversified energy business that is organized into six major business segments, namely: Utility; Exploration and Production; Pipeline and Storage; Timber; International; and Energy Marketing. The Utility segment (National Fuel Gas Distribution Company) sells or transports natural gas to approximately 735,000 customers through a local distribution system located in western New York and northwestern Pennsylvania; the Exploration and Production segment (Seneca Resources Corporation) explores for, develops and purchases natural gas and oil reserves in the Gulf Coast region of Texas and Louisiana, California, Wyoming, and the Appalachian region of the United States, and in the western Canadian provinces (Manitoba, Alberta and Saskatchewan); the Pipeline and Storage segment (National Fuel Gas Supply Corporation) provides interstate natural gas transportation and storage services for affiliated and nonaffiliated companies through an integrated regional gas pipeline system that extends 3,065 miles from southwestern Pennsylvania to the New York-Canadian border and 29 underground storage areas; the Timber segment (Highland Forest Resources, Inc. and Seneca Resources Corporation, Northeast Division) operates sawmills in northwestern Pennsylvania and markets timber from National's New York and Pennsylvania land holdings; the International segment (Horizon Energy Development, Inc. and Horizon Power, Inc.) invests in and manages foreign energy projects, primarily in the Czech Republic, as well as projects in the United States; and the Energy Marketing segment (National Fuel Resources, Inc.) markets and brokers natural gas and electricity and the provides energy management services for industrial, commercial, public authority and residential end-users throughout the northeast United States. National and its subsidiaries are hereinafter referred to collectively as the National System.

For the fiscal year ended September 30, 2000, National reported consolidated revenues of \$1.4 billion and net income of \$127.2 million. National Fuel Gas Distribution Company ("Distribution") contributed approximately 45.3% of National's net income, while National's principal non-utility subsidiaries, National Fuel Gas Supply Corporation and Seneca Resources Corporation, contributed 24.9% and 27.4%, respectively, of National's net income.

A. BACKGROUND: NATIONAL'S CURRENT FINANCING AUTHORITY

By order dated March 20, 1998,¹ as modified by order dated April 21, 2000 ² (as modified, the "1998 Order"), National and its subsidiaries are authorized to engage in a program of external financing, intrasystem financing and other related transactions for the period through December 31, 2002. Among

1 National Fuel Gas Company, et al., Holding Co. Act Release No. 26847.

2 National Fuel Gas Company, et al., Holding Co. Act Release No. 27170.

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other approvals granted, the Commission authorized National to (i) issue and sell from time to time additional long-term debt and equity securities outstanding at any one time not to exceed \$2 billion, (ii) issue and sell from time to time up to \$750 million principal amount of short-term debt in the form of commercial paper and borrowings under credit facilities having maturities of up to 270 days, and (iii) guarantee securities of its subsidiaries and provide other forms of credit support with respect to obligations of its subsidiaries as may be necessary or appropriate to enable such subsidiaries to carry on in the ordinary course of business in an aggregate amount not to exceed \$2 billion outstanding at any one time. Under the terms of the 1998 Order, National is authorized to use the proceeds of authorized financing to invest in and enter into guarantees with respect to the obligations of "exempt wholesale generators" ("EWGs") and "foreign utility companies" ("FUCOs"),³ provided that its "aggregate investment" (as defined under Rule 53) in EWGs and FUCOs does not exceed 50% of its "consolidated retained earnings" (also as defined in Rule 53), except for short-term borrowings by National to provide funds to the National System Money Pool, which may not be used to finance the acquisition of any interest in a FUCO or EWG. As of August 31, 2001, National's aggregate investment in EWGs and FUCOs was approximately \$130,074,000, or 22.3% of National's average consolidated retained earnings for the four quarters ended June 30, 2001 (\$583,737,000).

B. PROPOSED INCREASE IN AGGREGATE INVEST LIMIT

National is now requesting, pursuant to Rule 53(c), authority to increase its "aggregate investment" in EWGs and FUCOs (hereafter referred to collectively as "Exempt Projects") to \$750,000,000 (the "EWG/FUCO Investment Limit"), which is equal to approximately 128% of National's average consolidated retained earnings for the four quarters ended June 30, 2001.

National believes that, at this stage of the restructuring of the utility industry both in this country and abroad, it is critical that it have the flexibility to increase its investment in Exempt Projects in order to create maximum shareholder value. As described below, National has already made substantial investments in electric generation and thermal energy systems in the Czech Republic and is investigating potential investments in other similar facilities in eastern Europe and elsewhere. Domestically, National has made relatively modest investments in EWG facilities in New York that utilize landfill gas (methane) and natural gas as a fuel. National has explored possible investments in other similar domestic generation facilities as well as in existing generating plants that are being sold by electric utility companies under State restructuring initiatives.

3 The terms "exempt wholesale generator" and "foreign utility company" are defined, respectively, in Sections 32(a) and 33(a) of the Act.

For the reasons discussed in greater detail below, National believes that it has the capacity to fund from external sources investments in Exempt Projects in amounts significantly greater than 50% of its average consolidated retained earnings without impairing the financial condition of the National System or the ability of National to provide necessary capital to its domestic public utility operations. Accordingly, National requests that the Commission

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issue an order pursuant to Rule 53(c) under the Act modifying the 1998 Order in order to allow National to utilize the proceeds of financing and to issue guarantees, within the limits specified under the 1998 Order (or any order or orders hereafter issued that extend or renew National's authorization under the 1998 Order), to finance investments in Exempt Projects in an amount up to the proposed EWG/FUCO Investment Limit. As demonstrated in Item 3 of this Application/Declaration, National satisfies the applicable standards under Rule 53(c).

C. DESCRIPTION OF NATIONAL'S CURRENT PORTFOLIO OF EXEMPT PROJECTS

1. FUCOs

a. UNITED ENERGY, a.s.

National, through Horizon Energy Development, B.V. ("Horizon B.V."), owns an 84.76% interest in United Energy, a.s. ("UE"), which owns and operates wholesale power and heating facilities located in the northern Bohemian region of the Czech Republic. UE's revenues are derived from the sale of both electric energy and thermal energy produced from its generation facilities. UE also purchases heat for resale. UE's generating facilities have a capacity of 236 megawatts electric (MWe) and 1,253 megawatts thermal (MWt). UE sells the electricity it produces at wholesale to the local electric utility. Thermal energy is ultimately sold to residential, commercial and industrial customers. In calendar year 2000, UE had approximately 7,878 terajoules (TJ) of heat sales and approximately 1,114 gigawatthours (GWh) of electric sales.

b. TEPLARNA LIBEREC a.s.

National, through UE, owns a 70% interest in Teplarna Liberec a.s. ("Liberec"), which owns and operates wholesale power and district heating facilities located in the city of Liberec in the Czech Republic. Liberec's facilities include a 12 MWe back pressure steam turbine generator. In calendar year 2000, Liberec made heat sales totaling 1,549 TJ and wholesale sales of electricity totaling 45 GWh. Electric power was sold at wholesale to the local electric utility.

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c. TEPLARNA KROMERIZ, a.s.

National, through Horizon B.V., owns 100% of Teplarna Kromeriz, a.s. ("Kromeriz"), which owns and operates a district heating system in the town of Kromeriz in the Czech Republic. Kromeriz made heat sales of 168 TJ in calendar year 2000.

2. EWGS.

a. SENECA ENERGY II, LLC

National indirectly owns a 50% membership interest in Seneca Energy II, LLC, an EWG that generates approximately 11 MW of electricity from methane gas obtained from a landfill located in Waterloo, New York.

b. MODEL CITY ENERGY, LLC

National indirectly owns a 50% membership interest in Model City Energy, LLC, an EWG that generates approximately 5.5 MW of electricity from methane gas obtained from a landfill located in Model City, New York.

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c. ENERGY SYSTEMS NORTH EAST, LLC

National indirectly owns a 50% membership interest in Energy Systems North East, LLC, an EWG, which owns and operates an approximately 80 MW gas-fired generating facility in North East, Pennsylvania. The facility supplies thermal energy to Welch Foods, Inc. and markets the electric energy produced under a tolling arrangement.

D. RISK PROFILE OF NATIONAL'S INVESTMENTS IN EXEMPT PROJECTS

Investments in EWGs and FUCOs may involve a variety of risks that historically have not been present in the traditional, regulated, electric and gas utility industries in this country. The review process (the "Review Process") employed by National in evaluating and assessing the benefits and risks in any investment in an EWG or FUCO identifies and addresses (i.e., limits and/or mitigates) these risks as they relate to both domestic and, more significantly, foreign projects. The following is a discussion of these procedures and risks.

1. THE PROJECT REVIEW PROCESS

Every potential EWG and FUCO investment and acquisition opportunity (both domestic and foreign) considered by National is subjected to several stages of formal review to ensure both the alignment of the project with strategic objectives of National and the appropriate assessment of both the risks and rewards for the project. This review process applies to all new business opportunities, not simply Exempt Projects. The Review Process includes a detailed framework for each phase of the project development cycle.

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Initially, at the conceptual stage in the assessment of a proposed project or acquisition, National's Development Team must make a preliminary determination as to whether the project is consistent with National's strategic objectives and whether the project's risk and rewards ratio will be acceptable. National's Development Team consists of specialists in accounting, legal affairs, engineering, finance and operations. If deemed to be consistent with National's strategic objectives and the initial evaluation of the project's risks and rewards ratio is acceptable, then the Development Team is responsible for the preparation of a business concept document ("Pro Forma") for the project. The Pro Forma must address at a minimum the description of the business, an analysis of potential partnerships, a preliminary market assessment, a technical analysis, initial financial analysis, critical success factors, risks, estimated development costs, and exit strategies. Upon the completion of the Pro Forma, the Development Team and Management, must review it and make a determination that the project is consistent with National's corporate strategic objectives, and, given the identified risks, has the requisite earnings potential to merit further review through detailed due diligence.

National's Development Team will perform detailed project due diligence and risk assessment using in-country advisors, engineers, environmental auditors, accountants, tax advisors, attorneys, and investment bankers to evaluate the project. The Pro Forma will be updated and a business case will be developed. This business case, along with the results of the due diligence and risk assessment process performed in connection with the development of the business case, is to form the basis upon which the National Executives and the National Board of Directors will approve of the proposed

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investment in the project. The business case is to be a comprehensive identification and analysis of the strategic, market, operational, and financial components of the project. In addition to an assessment of the project, it will also include the identification of an exit strategy and identify initial project implementation steps. Its scope will be driven by the size, complexity, and risk associated with the project.

Upon completion of the Pro Forma and business case, a summary of the findings as well as a recommendation on whether, and if so, how, to proceed will be presented to the National Executives. Upon approval by the National Executives, the investment will be assessed against pre-approved Board investment criteria to determine the level of additional approvals, if any, that may be required. Depending on the magnitude of the investment in a project, full Board approval may be necessary.

As indicated, the above internal review process applies to all new National businesses, including Exempt Projects. Due to the --- special risks associated with foreign Exempt Projects, however, additional factors are considered. Before National makes any investment in a foreign country, the business case must include an analysis of country risk, which will be presented to and reviewed by National's Board of Directors. The analysis includes a review of the political and economic stability of the particular country, the government's commitment to private power, the extent to which there is a free market economy, the extent to which there is a developed local banking system, the legal and regulatory framework for private investment in electric or gas facilities, the local business support for long-term investment of private

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capital, currency conversion and repatriation, and the potential for future partial sales of the investment interest to other investors.

2. RISK MITIGATION MEASURES

As National expands its energy business in the future, National will carefully and systematically evaluate the potential risks of a project in connection with the development of the business case before National funds are committed. The risks evaluated include those discussed below.

a. OPERATING RISKS

National's experience in competing in a non-regulated environment through its non-utility subsidiaries (particularly the Pipeline and Storage, Exploration and Production, and International segments) enables National to anticipate and consequently mitigate risks associated with Exempt Projects. As indicated, National's non-utility subsidiaries contributed more than half of National's net income from operations for the fiscal year ended September 30, 2000, and that percentage is expected to grow over time.

Due diligence review of operating assumptions relating to any project include an analysis of fuel supply and environmental effects by appropriate personnel with experience in the technology being evaluated, supplemented as appropriate by the use of outside technical consultants. Other operating risks may, as appropriate, be mitigated by equipment warranties and by casualty, business interruption, and other forms of insurance. Further, operating risk may be mitigated in some instances by a subsidiary's direct participation in the administration and operation of a project; such direct involvement may enhance National's ability to identify and address developing and existing problems on a timely basis.

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b. CONSTRUCTION RISKS

Another element of National's risk mitigation policy is to achieve a balance between so-called "greenfield" projects and acquisitions of existing facilities and power systems. Greenfield projects are those that involve completely new development and construction of facilities, principally generating stations. Greenfield projects involve a higher degree of risk because they entail a lengthy process of development and construction. Funds are expended during the early years of such projects; and return on investment is not earned until the project is in operation. Nevertheless, while greenfield projects have higher levels of risk and deferred returns, they are important to National because they generally produce higher rates of return on investment than investments in existing assets and lay the foundation for continued earnings growth.

To the extent issues regarding construction risks arise, such risks are commonly mitigated by fixed-price contracts with milestones and performance guarantees (e.g., guaranteed rates and availability factors), backed by

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appropriate levels of liquidated damages. The creditworthiness and track record of the construction contractor is an important consideration in this regard. In those cases where a subsidiary of National may serve as its own general construction contractor, it will look to pre-negotiated cost and damage provisions from sub-contractors, including, without limitation, equipment vendors, to protect against performance shortfalls, cost overruns and schedule delays.

c. COMMERCIAL RISKS

In a competitive market, prices are determined by the economic laws of supply and demand. Accordingly, National System personnel will conduct extensive investigations of the foreign or domestic markets in which a particular project will operate. With respect to an EWG, a National System company will seek to ensure that the EWG will be capable of producing electricity at competitive rates in a non-regulated environment. National System personnel will also assess the underlying economic parameters in specific markets to assure that there will be sufficient demand for the output of the EWG.

d. FINANCIAL RISKS

National takes various issues into consideration in mitigating the financial risk associated with a proposed project. The Pro Forma analysis prepared for a proposed investment in a project by National will include an evaluation of whether the project cash flows will be able to support National's anticipated investment financing based on the traditional debt and equity financial structure that National attempts to maintain on a consolidated basis.

The Pro Forma analysis will also evaluate whether the project can support additional financial risk from debt financing at the project level. This evaluation will consider whether the project is of a sufficient size to enable permanent debt financing to be obtained at a reasonable cost and on a non-recourse basis to National. The use of non-recourse project debt means that this debt will be secured solely by the project's assets and revenues, and creditors have no ability to seek repayment upon default from National. This method of financing ensures that National's exposure to any project is limited to the amount of National's equity investment in the project.

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In determining the amount any non-recourse debt financing and associated financial risk for a particular project, National will also take into consideration the economic characteristics of the project. For example, if a project is supported by a long-term, fixed-price, "off-take" agreement with a third party, the project debt may be designed to be of a similar term, with scheduled debt payments covered by fixed charges. On the other hand, where there is no long-term, fixed source of revenue, the amount of non-recourse debt financing by the project would normally be smaller, so that undue financial risk is not incurred through excessive debt levels.

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e. INTEREST RATE RISK

A specific financing risk is the potential variability of interest rates. Interest rate variability can be addressed, in part, by borrowing on a fixed-rate basis or by purchasing financial instruments that fix or cap variable interest rates. The effects of interest rate volatility can be mitigated principally through two strategies: hedging and diversifying. Hedging techniques that National may utilize would limit the impact that rising interest rates have on floating rate debt instruments.⁴ Diversification implies that liabilities will be spread among short- and long-term debt instruments, as well as fixed and floating interest obligations.

As an example, National, through UE, has entered into an interest rate swap to eliminate interest rate fluctuations on a CZK (Czech koruna) denominated term loan having a variable interest rate equal to six month Prague Interbank Offered Rate (PRIBOR), plus 0.475%. Under the terms of the interest rate swap, which extends until 2002, National pays a fixed rate of 8.31% and receives a floating rate of six month PRIBOR.

f. FOREIGN CURRENCY EXCHANGE RISK

There are several ways in which National may address the foreign currency exchange risk element, depending on the status of the target country. Initially, National will seek to develop or acquire projects where there is free convertibility of the local currency into U.S. dollars. In countries that do not have a history of stability in the management of their exchange policy, National may require that part or all of the revenue from a project be payable in or indexed to hard currency (almost invariably U.S. dollars). Back-up guarantees or other undertakings by the central government may be available to ensure that the U.S. dollar payments due under a power purchase agreement are actually made available by the central bank or ministry of finance.

In other cases, some or all of the non-recourse project debt may be borrowed in the same currency as the project's revenues, thereby ensuring a match between debt service obligations and operating income. Where available, long-term currency swaps would provide a further hedging option for the equity component of the investment.

g. LEGAL RISKS

Legal risks will be addressed by careful review of any investment by legal counsel, including local and international counsel where foreign projects are concerned. Such legal reviews address regulatory and permitting risks, environmental risks, the adequacy and enforceability of guarantees or other

4 Under the terms of the 1998 Order, National is authorized to enter into interest rate hedging transactions to mitigate interest rate risk.

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contractual undertakings of third parties, the status of title to utility property, and the obligations inherent in the financing arrangements.

h. COUNTRY RISKS

In addition to the specific risks mentioned above, investment outside the United States can entail country-specific risks related to political or economic performance. As indicated above, National thoroughly evaluates country risk before committing to invest in any foreign project, and attempts to mitigate this risk through a number of measures. Most important, the country review process described above ensures that the political and economic stability of any country has been reviewed at several levels up to and, depending on the level of investment, including National's Board of Directors before any investment occurs. The country analysis also focuses specifically on the country's energy sector and on the government's support for private ownership in that sector.

In some instances, in order to mitigate risk, National has acquired interests in Exempt Projects that that are partly owned by local entities that are experienced in doing business in the host country. Having local participation in the ownership of an Exempt Project can in most cases greatly reduce the risk of future expropriation or unfair regulatory treatment in the host country. Another mitigating factor is the participation of official or multilateral agencies in an Exempt Project. When funds for the project are supplied by government-sponsored export credit agencies or other governments or institutions such as the World Bank through its International Finance Corporation affiliate, the host country has strong incentives not to take actions which would harm the project's viability.

Political risk may be addressed through political risk insurance obtained from the Overseas Private Investment Corporation, a United States agency, or the Multilateral Investment Guaranty Agency, a World Bank affiliate, or in the commercial insurance market. Political risk insurance is available to insure the project debt or the return of an investor's equity. One can also insure against outright expropriation, acts of civil violence, or even "creeping" nationalization brought about by punitive regulation. National will analyze the perceived risk and its costs and compare that with the cost of obtaining such insurance and, when such costs associated with such risks exceed the costs of insurance coverage, National will attempt to procure such insurance.

i. PORTFOLIO DIVERSIFICATION

National recognizes that the risk inherent in any investment cannot be eliminated entirely, even by the most careful approach to project development. However, National believes that diversification of both the type and location of projects can mitigate risk. Accordingly, National will evaluate opportunities across countries and regions of the world. On the other hand, National may balance its diversification strategy with another goal--i.e., to develop regional expertise.

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In the domestic sector, several electric utilities operating in the States in which Distribution operates (New York and Pennsylvania) and neighboring States have either sold or announced their intention to sell their electric generating properties as part of State-sponsored electric utility industry restructuring initiatives. National is actively considering acquiring existing electric generating assets in this region through affiliated EWGs. National believes that ownership of operating power plants, especially in its service territory, would present unique opportunities to leverage its existing experience and core competencies in such areas as customer relations, fuel management and supply, regulatory relations, and others. The acquisition of existing power plants would reduce the risk of National's overall business by producing near-term earnings without significant development or construction risk. Moreover, National believes that it can, through the expertise and resources of the National System companies, improve the operations of many existing generating projects that are available.

In the foreign sphere, National will continue to investigate opportunities to invest in "greenfield" power projects as well as utility systems that are the subject of privatization initiatives. Although National has not committed to invest in any particular foreign project (other than those described above), it is currently engaged in preliminary development activities in Europe.

j. EARNINGS FROM EXEMPT PROJECTS

National's investments in Exempt Projects have contributed positively to earnings in each of the past three fiscal years. For example, for the fiscal year ended September 30, 2000, National's investments in FUCOs have increased consolidated net income by approximately \$7.7 million. National expects that its investments in Exempt Projects will continue to generate positive earnings and contribute to consolidated earnings growth in the future.

k. EFFECT OF REGULATORY CHANGE

Regulatory change in the United States has served both to mitigate the risk of investing in EWGs and to increase the opportunities for investment in EWGs. Global regulatory changes and privatization have increased the opportunities to invest in FUCOs. In this environment, National can best enhance its future earnings growth, and thereby lower its overall cost of capital, through a broadly diversified program of developing and investing in Exempt Projects.

In the past several years, the United States (and North American) energy market has evolved into a competitive and liquid market, with open transmission access in the United States and substantial markets available through federal and state sponsored restructuring. This market has evolved since the passage of the Energy Policy Act of 1992 and particularly in the wake of the transmission access required by FERC Order 888 and the formation of independent regional transmission organizations, as envisioned by FERC Order 2000. The

Commission recognized the transfiguration of the energy market in the United States in its order adopting Rule 58:

As a result of Congressional action [i.e. the Energy Policy Act], combined

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with initiatives of the Federal Energy Regulatory Commission ("FERC") and the state and local ratemaking authorities, the pace of change in the gas and electric utility industry is accelerating. Today, the gas industry is largely deregulated and the electric industry is undergoing a similar process. In addition to increasing competition at the wholesale level, retail electric competition is developing more rapidly than anticipated, due to state efforts. Utilities and the suppliers of energy appear poised to compete in retail markets. As a result of these developments the contemporary gas and electric industries no longer focus solely upon the traditional production and distribution functions of a regulated utility, but are instead evolving toward a broadly based, competitive, energy services business.⁵

In addition, partially as a result of the Energy Policy Act, partially as a result of foreign nations opening government utility systems to private investment activity, and partially through utility restructuring, the global energy market has evolved to allow a much greater level of competition and outside investment. Participants in this market who seek to own or operate power generation must utilize a portfolio approach to investment and maintain investment levels sufficient to achieve the benefits of scale economies. National has successfully participated in this global market through investments in the Czech Republic. Continued success will require continued investment and growth.

ITEM 2. FEES, COMMISSIONS, AND EXPENSES

The fees, commissions, and expenses incurred or to be incurred in connection with this Application/Declaration are estimated to be \$20,000 (for legal fees and expenses).

ITEM 3. APPLICABLE STATUTORY PROVISIONS

A. GENERAL PROVISIONS

Sections 32 and 33 of the Act and Rule 53 of the Commission's rules thereunder are or may be applicable to the proposed transactions.

5 Holding Company Act Release No. 26667 (February 20, 1997), text at footnotes 19-21. See also The Regulation of Public-Utility Holding Companies, Report of the Division of Investment Management, Securities and Exchange Commission (June 1995), at 19-22, 26-27.

Rule 53 provides that, if each of the conditions of paragraph (a) thereof is met, and none of the conditions of paragraph (b) thereof is applicable, then the Commission may not make certain adverse findings under Sections 7 and 12 of the Act in determining whether to approve a proposal by a registered holding company to issue securities in order to finance an investment in any EWG or to guarantee the securities of any EWG. The Commission has applied these same criteria to financing of investments in FUCOs. Giving effect to the proposals contained herein, National will satisfy all of the conditions of Rule 53(a) except for clause (1) thereof, since National is proposing herein to

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increase its aggregate investment in EWGs and FUCOs to more than 50% of National's consolidated retained earnings. None of the conditions specified in Rule 53(b) is applicable.

B. COMPLIANCE WITH RULE 53(c)

Rule 53(c) states that, in connection with a proposal to issue and sell securities to finance an investment in any EWG, or to guarantee the securities of any EWG, a registered holding company that is unable to satisfy the requirements of paragraph (a) or (b) of Rule 53 must "affirmatively demonstrate" that such proposal:

- will not have a substantial adverse impact upon the financial integrity of the registered holding company system; and
- will not have an adverse impact on any utility subsidiary of the registered holding company, or its customers, or on the ability of State commissions to protect such subsidiary or customers.

In the past, the Commission has routinely issued orders under Rule 53(c) permitting other registered holding companies to finance investments in EWGs and FUCOs in amounts up to 100% of consolidated retained earnings.⁶ More recently, the Commission has authorized aggregate investment limits that are well above 100% of consolidated retained earnings. National Grid Group, plc ("National Grid"), for example, was authorized in early 2000 as part of its acquisition of New England Electric System to make additional investments in EWGs and FUCOs that would increase its aggregate investment to approximately 252% of its pro forma consolidated retained earnings.⁷ In late 2000, also as

6 See The Southern Company, Holding Co. Act Release No. 26501 (Apr. 1, 1996),

Central and South West Corporation, Holding Co. Act Release No. 26653 (Jan.

24, 1997), GPU, Inc., Holding Co. Act Release No. 26779 (Nov. 17, 1997),

Cinergy Corporation, Holding Co. Act Release No. 26848 (Mar. 23, 1998),

American Electric Power Company, Inc., Holding Co. Act Release No. 26864

(Apr. 27, 1998), New Century Energies, Inc., Holding Co. Act Release No.

26892 (Feb. 26, 1999), and Entergy Corporation, Holding Co. Act Release No.

27184 (Mar. 15, 2000).

7 See The National Grid Group plc, Holding Co. Act Release No. 27154 (Mar.

15, 2000).

part of a merger approval, the Commission authorized KeySpan Corporation ("KeySpan") to invest up to 250% of its pro forma consolidated retained earnings in EWGs and FUCOs.⁸ That was followed by an order issued to Cinergy Corp. ("Cinergy") in which the Commission authorized an increase in Cinergy's aggregate investment limit to an amount that is equal to the sum of its aggregate investment in EWGs and FUCOs at that time plus \$1 billion, or about

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154% of Cinergy's consolidated retained earnings.⁹ Subsequently, Cinergy obtained a supplemental order authorizing it to have an aggregate investment equal to 100% of its consolidated retained earnings plus \$2 billion, or an amount that would equal about 274% of Cinergy's current consolidated retained earnings.¹⁰ Exelon Corp. ("Exelon"), which has no history of investments in EWGs or FUCOs, was authorized in November 2000 to invest up to \$2 billion in EWGs and FUCOs, which was equivalent to about 264% of Exelon's "reclassified" pro forma consolidated retained earnings, an amount that was subsequently increased to \$4 billion.¹¹ Dominion Resources has filed an application requesting approval for an aggregate investment limit equal to 100% of consolidated retained earnings plus \$8 billion, which appears to be several times higher than Dominion's consolidated retained earnings.¹²

In each of these cases, the applicants compared the amount of the proposed aggregate investment limit to other relevant financial statistics, such as consolidated capitalization, consolidated net utility plant, total consolidated capitalization and the total market value of the applicant's common stock.

As previously indicated, an aggregate investment in Exempt Projects of \$750,000,000 would be equal to about 128% of National's average consolidated retained earnings for the four quarters ended June 30, 2001, which is substantially lower than the percentages found acceptable in National Grid,

KeySpan, Exelon and Cinergy orders.

8 See KeySpan Corporation, et al., Holding Co. Act Release No. 27272 (Nov. 8, 2000).

9 See Cinergy Corporation, Holding Co. Act Release No. 27190 (June 23, 2000).

10 See Cinergy Corporation, Holding Co. Act Release No. 27400 (May 18, 2001).

11 See Exelon Corporation, Holding Co. Act Release No. 27266 (Nov. 2, 2000) (authorizing aggregate investment limit of \$2 billion); and Exelon Corporation, Holding Co. Act Release No. 27296 (Dec. 8, 2000) (authorizing aggregate investment limit of \$4 billion).

12 File No. 70-9555. Dominion explains in its application that, due to the application of purchase method accounting in connection with its acquisition of Consolidated Natural Gas Company, its consolidated retained earnings do not reflect the retained earnings of Consolidated before the acquisition.

1. THE PROPOSED TRANSACTIONS WILL NOT HAVE A SUBSTANTIAL ADVERSE IMPACT UPON THE FINANCIAL INTEGRITY OF THE NATIONAL SYSTEM

The lack of any "substantial adverse impact" on National's financial integrity as a result of increased levels of investments in EWGs and FUCOs can

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be demonstrated in several ways, including the analysis of historic trends in National's consolidated capitalization ratios and retained earnings and the market view of National's securities. Consideration of these and other relevant factors supports the conclusion that the issuance of securities and guarantees by National to finance investments in EWGs and FUCOs exceeding the 50% consolidated retained earnings limitation in Rule 53(a)(1) will not have any "substantial adverse impact" on the financial integrity of the National System.

a. KEY FINANCIAL RATIOS/BENCHMARKS

i. CAPITALIZATION RATIOS

An aggregate investment in Exempt Projects of \$750,000,000 would represent a relatively small commitment of National's capital for a company the size of National, based on various key financial ratios at September 30, 2000. For example, investments of this amount would be equal to only 38.6% of National's total consolidated capitalization (\$1.941 billion), 53% of net utility plant (\$1.414 billion), 23.2% of total consolidated assets (\$3.237 billion), and 35.4% of the market value of National's outstanding common stock (\$2.121 billion) as of September 30, 2000. The following table shows how these percentages would compare to the comparable percentages for KeySpan, Exelon, Cinergy, Dominion, and Alliant Energy Corporation,¹⁴ as reflected in each company's Rule 53(c) application and/or as calculated based on financial information available for the year ended December 31, 2000 (except as otherwise indicated).

 13 Includes gas distribution, pipeline and storage plant.

14 See Alliant Energy Corporation, File No. 70-9891.

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Proposed Investments in EWGs and FUCOs as a percentage of:

| Company | Consolidated Capitalization | Consolidated Net Utility Plant | Total Consolidated Assets | Market Value of Common |
|--------------------------|--------------------------------|-----------------------------------|------------------------------|---------------------------|
| KeySpan (6/30/00) | 16.6% | 20.9% | 11.5% | 29.2% |
| Exelon Corp. | 18.9% | 23.3% | 11.1% | 28.2% |
| Cinergy Corp. | 46% | 47.5% | 25.6% | 56% |
| Dominion (pending) | 42.0% | 60.8% | 30.7% | 54.6% |
| Alliant Energy (pending) | 37.7% | 55.7% | 26.0% | 69.6% |
| National (9/30/00) | 38.6% | 53% | 23.2% | 35.4% |

ii. NATIONAL SECURITY RATINGS

National's long-term debt has been rated by Standard & Poor's Corporation ("S&P"), Moody's Investor Service ("Moody's"), and Fitch Investor Service ("Fitch") as follows:

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NATIONAL'S LONG-TERM DEBT RATINGS (AS OF 9/30)

| | 1998 | 1999 | 2000 | CURRENT |
|---------|------|------|------|---------|
| S&P | A- | A- | A- | A- |
| Moody's | A-2 | A-2 | A-2 | A-2 |
| Fitch | A | A | A | A |

iii. CONSOLIDATED RETAINED EARNINGS

Excluding the effects of accounting changes relating to National's oil and gas exploration and production operations, National's consolidated retained earnings have grown on average approximately 10% per year over the five years ended September 30, 2000, which is within the range of growth rates for other integrated gas companies, as well as other registered holding company systems that have obtained relief under Rule 53(c).

iv. NATIONAL'S DEBT LIMITATIONS

Currently, National is restricted under the terms of its 1974 indenture in the amount of additional long-term debt (funded debt) that it may issue. Generally, National may not issue additional long-term debt unless, after giving effect to each issuance, (i) outstanding long-term debt does not exceed 60% of the consolidated assets of National, and (ii) income available for

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interest and subsidiary preferred stock dividends for any 12 consecutive months within the preceding 15 months has been at least two times the sum of annual interest charges and subsidiary dividend requirements.¹⁵ For the twelve-month periods ended September 30, 1999 and 2000, these coverage ratios were 4.25 times and 4.48 times, respectively.

v. RULE 53(B) FACTORS

As previously indicated, none of the circumstances described under Rule 53(b) has occurred. National undertakes to notify the Commission by filing a post-effective amendment in this proceeding in the event of the occurrence of any of these circumstances.

vi. OTHER INDICATORS

Other financial indicators show the financial strength of National. For example, National's diluted earnings per share and return on average equity were \$2.95 and 12.6%, respectively, for the fiscal year ended September 30, 1999 and \$3.21 and 13.2%, respectively, for the fiscal year ended September 30, 2000. For comparison purposes, the following table lists diluted earnings per share and return on average equity for other "peer group" utilities for the year ended December 31, 2000:

| Company | Earnings Per Share | Return on Equity |
|---------------------------|--------------------|------------------|
| KeySpan Corp. | \$2.10 | 10.1% |
| Equitable Resources, Inc. | 1.60 | 13.4 |
| Kinder Morgan, Inc. | 1.32 | 7.5 |

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| | | |
|---------------------------|------|------|
| Oneok, Inc. | 1.11 | 12.3 |
| Questar Corporation | 1.94 | 16.2 |
| NiSource Inc. | 1.15 | 6.6 |
| National (Sept. 30, 2000) | 3.21 | 13.2 |

b. MARKET ASSESSMENT OF NATIONAL

i. ASSESSMENT OF GROWTH AND EARNINGS

The market's assessment of National's future growth and earnings can also be shown by comparison of National to the same "peer group" utilities based on price-earnings ratio and market-to-book ratio for 2000. These measures indicate investor confidence in National and have been cited as favorable indicators in other orders the Commission has issued under Rule 53(c).

 15 National's subsidiaries do not currently have any preferred stock outstanding.

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| Company | P/E Ratio | Market to Book Ratio |
|---------------------------|-----------|----------------------|
| KeySpan Corp. | 20.2 | 2.05 |
| Equitable Resources, Inc. | 20.9 | 3.13 |
| Kinder Morgan, Inc. | 39.5 | 3.32 |
| Oneok, Inc. | 16.3 | 1.16 |
| Questar Corporation | 15.5 | 2.45 |
| NiSource Inc. | 26.7 | 1.86 |
| National (Sept. 30, 2000) | 17.2 | 2.23 |

ii. DIVIDEND PAYOUT RATIO

National's indicated dividend rate at September 30, 2000 was \$1.92 per share. National's payout ratio (60%) is lower than the utility industry average of 82%.16

2. THE PROPOSED TRANSACTIONS WILL NOT HAVE AN ADVERSE IMPACT ON DISTRIBUTION OR ITS CUSTOMERS, OR ON THE ABILITY OF DISTRIBUTION'S STATE PUBLIC UTILITY COMMISSIONS TO PROTECT SUCH CUSTOMERS

National's request to increase its aggregate investment in Exempt Projects to \$750,000,000 will not have an "adverse impact" on Distribution, its customers, or on the ability of the two State commissions having jurisdiction over Distribution to protect Distribution or such customers.

The conclusion that Distribution and its customers will not be adversely impacted by increased levels of investment by National in Exempt Projects is well supported by (i) the insulation of Distribution and its customers from potential direct adverse effects of investments in Exempt Projects; (ii) analyses of Distribution financial integrity; and (iii) the proven effectiveness of state commission oversight to protect ratepayers in their respective states from any adverse impact.

a. INSULATION FROM RISK

All of National's investments in Exempt Projects are, and in the

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future will remain, segregated from Distribution. Thus, Distribution is, and is currently expected in the future to remain, insulated from the direct effects of investments by National in Exempt Projects. Any losses that may be incurred by such Exempt Projects would have no effect on domestic rates of Distribution. National represents that it will not seek recovery through higher rates to

16 Source: Standard & Poor's Corporate Ratings Criteria 2001.

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Distribution's utility customers in order to compensate National for any possible losses that it or any National System company may sustain on investments in Exempt Projects or for any inadequate returns on such investments.

National has complied and will continue to comply with the requirements of Rule 53(a)(3) regarding the limitation on the use of Distribution's employees in connection with providing services to EWGs and FUCOs. Increased levels of investment in EWGs and FUCOs are not anticipated to have any impact on utilization of Distribution employees. Distribution has not and will not increase staffing levels to support the operations of EWGs and FUCOs. National expects that project development, management, and home office support functions for EWGs and FUCOs will largely be performed by outside consultants (e.g., engineers, investment advisors, accountants, and attorneys) engaged by Horizon or other non-utility subsidiaries. Accordingly, National's need for the support of personnel provided by Distribution has been, and is expected to continue to be, limited to corporate governance services.

Finally, National has complied and will continue to comply with the other conditions of Rule 53(a) providing specific protections to customers of Distribution and its state commissions, in particular, the requirements of Rule 53(a)(1) regarding the preparation and making available of books and records and financial reports regarding EWGs and FUCOs, and the requirements of Rule 53(a)(4) regarding filing of copies of applications and reports with other regulatory commissions.

b. DISTRIBUTION'S FINANCIAL INTEGRITY

Distribution is in excellent financial health, as indicated by such factors as its debt/equity ratio. At September 30, 2000, debt (including short-term debt) as a percentage of Distribution's consolidated capitalization was equal to 44%, compared to 50.5%, the current industry median for U.S. utilities.¹⁷ Moreover, additional investments in EWGs and FUCOs by National will not have any negative impact on Distribution's ability to fund operations and growth. As shown in the table below, present projections indicate that Distribution will continue to fund its operations and its construction expenditures from internal sources of cash for at least the next 5 years. Distribution does not project the need for any increased amount of capital from National.

17 Source: Standard & Poor's Corporate Ratings Criteria 2001.

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DISTRIBUTION - CONSTRUCTION EXPENDITURES: ACTUAL (FY 1998-2000) AND PROJECTED (FY 2001 - 2005) EXPENDITURES, INCLUDING ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION AND PERCENTAGE INTERNALLY GENERATED

| Year | Budget (\$ million) | % Internally Generated |
|------|---------------------|------------------------|
| 1998 | 50.680 | 91 |
| 1999 | 46.974 | 181 |
| 2000 | 55.799 | 67 |
| 2001 | 49.541 | 197 |
| 2002 | 48.100 | 132 |
| 2003 | 47.100 | 131 |
| 2004 | 46.600 | 127 |
| 2005 | 46.100 | 126 |

c. ADEQUACY OF STATE COMMISSION OVERSIGHT

National believes that the New York State Public Service Commission and the Pennsylvania Public Utility Commission (the "State Commissions") have the authority and resources available under applicable public utility codes to protect Distribution's utility customers from any adverse impacts associated with National's investments in Exempt Projects. Significantly, the State Commissions have not raised objections to National's current investments in EWGs or FUCOs.¹⁸ Moreover, other registered holding companies with subsidiaries subject to the jurisdiction of one or the other of the State Commissions (e.g., GPU, Exelon, KeySpan) have been permitted to increase their aggregate investment in EWGs and FUCOs over the 50% consolidated retained earnings limit of Rule 53(a).

C. COMPLIANCE WITH RULE 54

Rule 54 provides that the Commission, in determining whether to approve the issue or sale of a security by a registered holding company for purposes other than the acquisition of an EWG or FUCO, or other transactions by such registered holding company or its subsidiary other than with respect to EWGs and FUCOs, shall not consider the effect of the capitalization or earnings of any subsidiary which is an EWG or FUCO upon the registered holding company system if the provisions of Rule 53(a), (b) and (c) are satisfied. If the transactions contemplated hereby are consummated and National's aggregate investment in EWGs and FUCOs exceeds 50% of its consolidated retained earnings, the provisions of Rule 53(a) will not be satisfied. However, to enable the

 18 Section 33(c)(2) provides that the State commissions may make recommendations to the Commission regarding a registered holding company's relationship to FUCOs, and that the Commission shall "reasonably and fully consider" such recommendations.

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Commission to monitor the impact of the transactions for which authority is sought hereby, National proposes to report the following additional information in the quarterly Rule 24 certificates it is filing in accordance with the 1998 Order:

1. A Rule 53(a) computation--that is a calculation of the ratio of National's aggregate investment in EWGs and FUCOs to National's average consolidated retained earnings (both as determined in accordance with Rule 53(a));
2. A statement of aggregate investment as a percentage of the following: total capitalization, net utility plant, total consolidated assets, and market value of common equity, all as of the end of that quarter;
3. Consolidated capitalization ratios as of the end of that quarter;
4. The market-to-book ratio of National's common stock at the end of that quarter;
5. An analysis of the growth in consolidated retained earnings, which segregates total earnings growth attributable to EWGs and FUCOs from that attributable to other National subsidiaries; and
6. A statement of revenues and net income of each material National System company for the twelve months ended as of the end of that quarter.

This information is the same as that required by the Commission with respect to the other registered systems that have obtained relief under Rule 53(c). National believes that such reporting requirements will assist the Commission in its determinations concerning the effect of investments in Exempt Projects on other transactions for which National and other National System companies will require Commission authorization.

ITEM 4. REGULATORY APPROVAL

The issuance and sale of securities by National and the use of the proceeds thereof to acquire or guarantee the securities of any EWG or FUCO are not subject to the jurisdiction of any state commission or of any federal commission other than the Commission. National will comply with the requirements of Rule 53(a) (4) by submitting a copy of this Application/Declaration to each of the State Commissions.

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ITEM 5. PROCEDURE

National requests, pursuant to Rule 23(c) of the Rules and Regulations of the Commission, that the Commission's order granting, and permitting this Application/Declaration to become effective be issued forthwith. National waives any recommended decision by a hearing officer or other responsible officer of the Commission and waives the 30-day waiting period between the issuance of the Commission's order and the date it is to become effective, since National desires that the Commission's order, when issued, become effective immediately.

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National consents to the Division of Investment Management assisting in the preparation of the Commission's decision and/or order in this matter, unless such Division opposes the matters covered by this Application/Declaration.

ITEM 6. EXHIBITS AND FINANCIAL STATEMENTS

(a) Exhibits

- F Opinion of Counsel (to be filed by amendment)
- G Proposed Form of Federal Register Notice

(b) Financial Statements

- FS-1 National Consolidated Financial Statements as of September 30, 2000 (incorporated by reference to the Annual Report on Form 10-K of National for the fiscal year ended September 30, 2000 (File No. 1-3880)).
- FS-2 National Consolidated Financial Statements as of June 30, 2001 (incorporated by reference to the Quarterly Report on Form 10-Q of National for the quarter ended September 30, 2001 (File No. 1-3880)).

ITEM 7. INFORMATION AS TO ENVIRONMENTAL EFFECTS

None of the matters that are the subject of the Application/Declaration involve a "major federal action" nor do they "significantly affect the quality of the human environment" as those terms are used in section 102(2)(C) of the National Environmental Policy Act. The transaction that is the subject of this Application/Declaration will not result in changes in the operation of National or its subsidiaries that will have an impact on the environment. National is not aware of any federal agency that has prepared or is preparing an environmental impact statement with respect to the transactions that are the subject of this Application/Declaration.

SIGNATURE

Pursuant to the requirements of the Public Utility Holding Company Act of 1935, as amended, the undersigned company has duly caused this Application/Declaration to be signed on its behalf by the undersigned thereunto duly authorized.

NATIONAL FUEL GAS COMPANY

By: /s/ James R. Peterson

Name: James R. Peterson
Title: Assistant Secretary

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Date: October 9, 2001