Regulatory Analysis Form
(Completed by Promulgating Agency)

IRRC
Independent Regulatory Review Commission

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SECTION I: PROFILE

(1) Agency:
Public Utility Commission

(2) Agency Number:
L-2008-2069114

Identification Number:

IRRC Number: 57-269 2772

(3) Short Title:
Natural Gas Distribution Companies and the Promotion of Competitive Retail Markets

(4) PA Code Cite:
52 Pa. Code §§ 62.221-62.227

(5) Agency Contacts (List Telephone Number, Address, Fax Number and Email Address):

Primary Contact:
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(6) Primary Contact for Public Comments (List Telephone Number, Address, Fax Number and Email Address) – Complete if different from #5:

Same.

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(All Comments will appear on IRRC'S website)

(7) Type of Rulemaking (check applicable box):

- [x] Proposed Regulation
- [ ] Final Regulation
- [ ] Final Omitted Regulation
- [ ] Emergency Certification Regulation;
  - [ ] Certification by the Governor
  - [ ] Certification by the Attorney General

(8) Briefly explain the regulation in clear and nontechnical language. (100 words or less)

The regulation is intended to remove barriers to retail competition in the market for natural gas supplies in the Commonwealth. It does this by requiring the natural gas distribution company (NGDC) to remove the effect of certain costs from base rates and to record them as if they were recovered through fuel acquisition costs so that there will be a more accurate price to compare for shoppers. Rules for programs by which NGDCs purchase the accounts receivables of electric generation suppliers are also included as are rules requiring that the release of interstate pipeline capacity held by NGDCs be nondiscriminatory and at the applicable pipeline rate. NGDCs are also given the opportunity to recover their incremental costs of implementing these rules as well as a direct recovery of PUC annual assessments from customers.

(9) Include a schedule for review of the regulation including:

A. The date by which the agency must receive public comments:	45 days after publication
B. The date or dates on which public meetings or hearings will be held:	unknown
C. The expected date of promulgation of the proposed regulation as a final-form regulation:	unknown
D. The expected effective date of the final-form regulation:	unknown
E. The date by which compliance with the final-form regulation will be required:	unknown
F. The date by which required permits, licenses or other approvals must be obtained:	unknown

(10) Provide the schedule for continual review of the regulation.

PUC will review compliance as part of its on-going supervision of the natural gas utility industry and, particularly, on an annual basis through 66 Pa. C.S. § 1307(a) and (f).

SECTION II: STATEMENT OF NEED

(11) State the statutory authority for the regulation. Include specific statutory citation.

66 Pa. C.S. § 2204(g) of the Natural Gas Choice and Competition Act required the PUC to review the state of competition in the natural gas retail market five years after passage of the Act. If it found there was no competition it was to convene a stakeholders working group and to "explore avenues, including legislative, for encouraging increased competition in this Commonwealth." The PUC did this and found that there was no effective competition. This regulation is one part of the PUC's efforts to increase competition in Pennsylvania.

(12) Is the regulation mandated by any federal or state law or court order, or federal regulation? Are there any relevant state or federal court decisions? If yes, cite the specific law, case or regulation as well as, any deadlines for action.

66 Pa. C.S. § 2204(g)

(13) State why the regulation is needed. Explain the compelling public interest that justifies the regulation. Describe who will benefit from the regulation. Quantify the benefits as completely as possible and approximate the number of people who will benefit.

In a report to the Legislature in October 2005, the PUC found that effective competition in the retail market for natural gas supplies did not exist in the Commonwealth. The Legislature, in the Natural Gas Choice and Competition Act, 66 Pa. C.S. §§ 2201-2212, had stated that natural gas costs for Pennsylvania consumers would be lowered by the results of competition among gas suppliers. This regulation is one of a number of initiatives launched by the PUC in order to foster competition. Greater competition should lower gas costs for all Pennsylvania users of natural gas, although the amount of that benefit cannot be quantified at this time.

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(14) If scientific data, studies, references are used to justify this regulation, please submit material with the regulatory package. Please provide full citation and/or links to internet source.

Investigation into the Natural Gas Supply Market: Report to the General Assembly On Competition In Pennsylvania's Retail Natural Gas Supply Market, Docket No. I-00040103, Investigatory Order and Report To the General Assembly, entered October 6, 2005.
http://www.puc.state.pa.us/naturalgas/naturalgas_issues.aspx

Investigation into the Natural Gas Supply Market: Report on Stakeholders' Working Group (SEARCH); Action Plan for Increasing Effective Competition in Pennsylvania's Retail Natural Gas Supply Services Market, Docket No. I-00040103F0002, Final Order and Action Plan entered September 11, 2008.
http://www.puc.state.pa.us/naturalgas/naturalgas_stakeholders_wg.aspx

(15) Describe who and how many will be adversely affected by the regulation. How are they affected?

The larger NGDCs in Pennsylvania may experience some small increases in administrative costs, but the regulation allows them to recover these costs from ratepayers. Any increase in ratepayers' costs should be outweighed by reductions in the costs of natural gas due to competitive market forces.

(16) List the persons, groups or entities that will be required to comply with the regulation. Approximate the number of people who will be required to comply.

All natural gas utilities falling within the definition of "Natural gas distribution company" at 66 Pa. C.S. § 2202. NGDCs will be expected to comply with this regulation. There are 10 NGDCs that will need to comply with this regulation.

SECTION III: COST AND IMPACT ANALYSIS

(17) Provide a specific estimate of the costs and/or savings to the **regulated community** associated with compliance, including any legal, accounting or consulting procedures which may be required. Explain how the dollar estimates were derived.

Costs cannot be estimated.

(18) Provide a specific estimate of the costs and/or savings to **local governments** associated with compliance, including any legal, accounting or consulting procedures which may be required. Explain how the dollar estimates were derived.

None.

(19) Provide a specific estimate of the costs and/or savings to **state government** associated with the implementation of the regulation, including any legal, accounting, or consulting procedures which may be required. Explain how the dollar estimates were derived.

None.

(20) In the table below, provide an estimate of the fiscal savings and costs associated with implementation and compliance for the regulated community, local government, and state government for the current year and five subsequent years. **Costs cannot be estimated.**

	Current FY Year	FY +1 Year	FY +2 Year	FY +3 Year	FY +4 Year	FY +5 Year
SAVINGS:	$	$	$	$	$	$
Regulated Community						
Local Government						
State Government						
Total Savings						
COSTS:						
Regulated Community						
Local Government						
State Government						
Total Costs						
REVENUE LOSSES:						
Regulated Community						
Local Government						
State Government						
Total Revenue Losses						

(20a) Provide the past three year expenditure history for programs affected by the regulation.

Program	FY -3	FY -2	FY -1	Current FY
N/A				

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(21) Explain how the benefits of the regulation outweigh any cost and adverse effects.

As noted above, the incremental costs of compliance should be far outweighed by the overall cost savings achieved through the benefits of lower natural gas supply costs in a competitive retail marketplace.

(22) Describe the communications with and input from the public and any advisory council/group in the development and drafting of the regulation. List the specific persons and/or groups who were involved.

Please see the PUC orders and reports referenced in response to no. 14.

(23) Include a description of any alternative regulatory provisions which have been considered and rejected and a statement that the least burdensome acceptable alternative has been selected.

Please see the PUC orders and reports referenced in response to no. 14.

(24) Are there any provisions that are more stringent than federal standards? If yes, identify the specific provisions and the compelling Pennsylvania interest that demands stronger regulations.

N/A

(25) How does this regulation compare with those of other states? How will this affect Pennsylvania's ability to compete with other states?

By and large the commitment of state governments to retail competition for natural gas supply vary. There is some discussion of those programs followed in other states in the reports referenced in response to no. 14. To the extent retail competition is achieved in Pennsylvania, it will make natural gas users in the Commonwealth more competitive with those in other states by reducing their costs.

(26) Will the regulation affect any other regulations of the promulgating agency or other state agencies? If yes, explain and provide specific citations.

No.

(27) Submit a statement of legal, accounting or consulting procedures and additional reporting, recordkeeping or other paperwork, including copies of forms or reports, which will be required for implementation of the regulation and an explanation of measures which have been taken to minimize these requirements.

The regulations will result in additional reporting by the NGDCs. They will have to file annual, quarterly or monthly adjustments of the proposed adjustment clause mechanisms as well as establish tariff riders for them. However, with regard to measures to minimize the requirements, the reporting and rate adjustment filings are to occur simultaneously with already existing PUC regulations regarding adjustment clause mechanisms, i.e., the purchase gas charge. Therefore, the increased reporting requirements are being kept to a minimum.

(28) Please list any special provisions which have been developed to meet the particular needs of affected groups or persons including, but not limited to, minorities, elderly, small businesses, and farmers.

N/A

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FACE SHEET
FOR FILING DOCUMENTS
WITH THE LEGISLATIVE REFERENCE BUREAU

(Pursuant to Commonwealth Documents Law)

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Copy below is hereby approved as to form and legality. Attorney General.	Copy below is hereby certified to be true and correct copy of a document issued, prescribed or promulgated by:	Copy below is hereby approved as to form and legality. Executive or independent Agencies.
BY Amy M. Elliott (DEPUTY ATTORNEY GENERAL)	Pennsylvania Public Utility Commission (AGENCY)	BY Bohdan R. Pankiw Bohdan R. Pankiw Chief Counsel
JUN 09 2009 DATE OF APPROVAL	DOCUMENT/FISCAL NOTE NO. L-2008-2069114/57-269	3-26-09 DATE OF APPROVAL
	DATE OF ADOPTION March 26, 2009	
☐ Check if applicable Copy not approved. Objections attached	BY James J. McNulty James J. McNulty TITLE Secy (SECRETARY)	☐ Check if applicable. No Attorney General approval or objection within 30 days after submission.

L-2008-2069114/57-269
Proposed Rulemaking
NGDCs and the Promotion of
Competitive Retail Markets
52 Pa. Code, Chapter 62

The Pennsylvania Public Utility Commission on March 26, 2009, adopted a proposed rulemaking order which ensures that consumers of natural gas will be able to shop for gas that is marketed on a level playing field for all market participants. The contact person is Lawrence F. Barth, Law Bureau, (717) 772-8579.

EXECUTIVE SUMMARY
L-2008-2069114/57-269

Proposed Rulemaking Re
Natural Gas Distribution Companies and the Promotion
Of Competitive Retail Markets
52 Pa. Code, Chapter 62

The purpose of this *Proposed Rulemaking Order* is to remove barriers to retail competition in the market for natural gas supplies in the Commonwealth. In order to facilitate the completion of our responsibility under the Natural Gas Choice and Competition Act (Act), 66 Pa. C.S. §§ 2201-2212, the Commission is undertaking this rulemaking proceeding. Section 2204(g) of the Act required the PUC to investigate as to whether there is "effective competition for natural gas supply" five years after passage of the Act. If the Commission found there is no effective competition, the Act required it to explore avenues for encouraging increased competition in the Commonwealth. Having found that there is no effective competition in the Commonwealth, the Commission is initiating three different rulemaking proceedings to encourage competition.

This rulemaking addresses issues pertaining to natural gas distribution companies (NGDCs). It does this by requiring NGDCs to remove the effect of certain costs from base rates and to record them as if they were recovered through fuel acquisition costs so that there will be a more accurate price to compare for shoppers. Moreover, the proposed regulations require that NGDCs record and report gas supply costs on a monthly basis so as to provide consumers with more accurate price signals. Rules for programs by which NGDCs purchase the accounts receivables of electric generation suppliers are also included as are rules requiring that the release of interstate pipeline capacity held by NGDCs be nondiscriminatory and at the applicable pipeline rate. NGDCs are also given the opportunity to recover their incremental costs of implementing these rules as well as a direct recovery of PUC annual assessments from customers.

The contact persons for this proposed rulemaking are Assistant Counsel Lawrence F. Barth, Law Bureau (717) 772-8579, lbarth@state.pa.us (legal), and Richard Wallace, Bureau of Audits, (717) 787-7236, riwallace@state.pa.us (technical).

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA. 17105-3265

Public Meeting held March 26, 2009

Commissioners Present:

James H. Cawley, Chairman
Tyrone J. Christy, Vice Chairman
Robert F. Powelson
Kim Pizzingrilli
Wayne E. Gardner

Natural Gas Distribution Companies and the Promotion of Competitive Retail Markets	Docket No. L-2008-2069114

PROPOSED RULEMAKING ORDER

BY THE COMMISSION:

The *Natural Gas Choice and Competition Act*, 66 Pa. C.S. §2201-12 (Competition Act), was enacted by the Legislature in 1999 with the purpose of restructuring the natural gas industry to allow the retail sale of natural gas in an open market. Based upon our experience to date, we are initiating a rulemaking proceeding to adopt regulations governing the relationships between Natural Gas Distribution Companies (NGDCs) and the Natural Gas Suppliers (NGSs) which sell, or seek to sell natural gas to end users on the NGDC distribution systems. We initiated this rulemaking to comply with the Legislature's directive, explained below, and to ensure that consumers of natural gas will be able to shop for gas that is marketed on a level playing field for all market participants.

The Competition Act allows individual customers to choose from independent suppliers of gas which are not necessarily affiliated with the local gas utility. Additionally, the Competition Act in section 2204(g), required the Pennsylvania Public Utility Commission (Commission) to initiate a look-back appraisal of how retail competition is progressing after passage of the Act. This investigation was to include participation of all interested parties so that a thorough examination of retail competition might be completed. *Id.*

In October 2006, we issued our *Report to the General Assembly on Pennsylvania's Retail Natural Gas Supply Market* (*Report to the General Assembly*),[1] in which we determined that effective competition did not exist in Pennsylvania's retail natural gas market. If the Commission found that "effective competition" did not exist, it was to reconvene the stakeholders in the natural gas industry to "explore avenues...for encouraging increased competition in this Commonwealth." *Id.* As the Report to the General Assembly noted:

> Based on the factors we have adopted to consider whether "effective competition" exists for purposes of Section 2204(g), these findings support the ultimate conclusion that there is a lack of "effective competition" in Pennsylvania's retail natural gas supply market at this time.

Report to the General Assembly at 67. We, therefore, convened the Natural Gas Stakeholders Group to explore avenues for increasing competition.

The work and report of that stakeholders' working group is detailed in our Final Order and Action Plan[2] (Action Plan) issued in September 2008. We concluded that there were a number of steps which we could take to help promote the development of competition in the retail markets for natural gas supply in the Commonwealth. There were three areas in which we believed it was appropriate to commence rulemakings to adopt regulations which were consistent with the goal of nurturing a robust retail market for natural gas. *Action Plan* at 7.

Today we address the first of those areas, that relating to NGDCs and their relation to the retail supply market. *Action Plan* at 13-23. There are five issues which address the

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1 *The Report to the General Assembly* was released in October 2005 at Docket No. I-00040103 and may be accessed at http://www.puc.state.pa.us/PcDocs/570097.pdf.

2 *Investigation into the Natural Gas Supply Market: Report on Stakeholders' Working Group (SEARCH); Action Plan for Increasing Effective Competition in Pennsylvania's Retail Natural Gas Supply Services Market,* Docket No. I-00040103F0002, Final Order and Action Plan entered September 11, 2008.

duties, rights and obligations of NGDCs. They are set forth in Annex A and discussed immediately below.

1. Reformulation of the Price to Compare

The Price to Compare (PTC) lies at the heart of retail choice. It is the means by which consumers can judge whether the price offered by an NGS is more or less than the default service rate. We have found that there are two obstacles to market entry, originally identified by suppliers, which impede the growth of the market:

> The first barrier involved the costs that are incurred in the acquisition of natural gas supply, but that were excluded from the NGDC's PTC. Because the NGDC's PTC does not include all of the costs of gas supply acquisition, the PTC may present an artificially low price, making it difficult for the NGSs to compete against the NGDCs for customers. *Report to the General Assembly*, p. 60.
>
> The second barrier identified by suppliers was the quarterly adjustment of the PTC pursuant to Section 1307(f). 66 Pa.C.S. § 1307(f). This adjustment creates a lag in recognizing increased gas costs so that consumers are confused as to the actual cost of the natural gas over time, and are lulled into thinking that the PTC is an annual fixed rate. In actuality, the NGDC's PTC represents a variable price with quarterly true-ups. *Report to the General Assembly*, p. 61.

Action Plan at 14.

The proposed regulation at 52 Pa. Code. § 62.223 is intended to remove the effect of those natural gas procurement costs now included in NGDC base rates which mask and understate the true cost of the commodity. Eventually, as NGDCs file base rate proceedings under 66 Pa. C.S. § 1308(d), these procurement costs will permanently be removed from base rates. The purpose of this regulation is to make the PTC rate reflect the same type of commodity costs which are incurred and charged to their customers by the NGSs. The more commonality between the elements of the NGDC and NGS natural gas supply costs, the easier it will be for consumers to compare prices and make choices among those offers of natural gas for sale. As much as possible that comparison should be one of apples to apples. This change should help make that so.

Generally, purchase gas cost (PGC) expenses include the cost of the natural gas itself as well as everything spent to get the gas through the interstate pipeline system to the city gate:

> [T]he terms "natural gas costs" and "gas costs" include the direct costs paid by a natural gas distribution company for the purchase and the delivery of natural gas to its system in order to supply its customers. Such costs may include costs paid under agreements to purchase natural gas from sellers; costs paid for transporting natural gas to its system; costs paid for natural gas storage service from others, including the costs of injecting and withdrawing natural gas from storage; all charges, fees, taxes and rates paid in connection with such purchases, pipeline gathering, storage and transportation; and costs paid for employing futures, options and other risk management tools. "Natural gas" and "gas" include natural gas, liquified natural gas, synthetic natural gas and any natural gas substitutes.

66 Pa. C.S. § 1307(h). However, there are elements of gas procurement expense which remain in base rates. We are not going to specify every individual cost which should be removed from base rates. Differences in operations and nomenclature would make such a task unwieldy and risk missing some costs because the specific name was not included. However, it should be obvious that this will apply to **all** fuel procurement-related costs. This includes, for example, operation and maintenance expense, any procurement-related investment costs, and payroll costs for employees involved in supply acquisition.

By creating the net gas procurement adjustment tariff rider to recognize the amount of procurement costs currently in base rates and moving the impact of these costs along with the PGC costs to the PTC, there will be a more valid comparison between NGDC and NGS rates and, therefore, an accurate PTC. We believe these can be adjusted annually within the context of the section 1307(f) process. Nonetheless, we recognize that these proceedings may require more time, at least initially. Therefore, we will direct that it be filed contemporaneously with the NGDC's section 1307(f) filing, but docketed separately. The two cases may be consolidated for litigation purposes, but the 1307(f) rate, which must be implemented based upon a firm schedule, can go into effect when scheduled without waiting for the conclusion of the determination of the tariff rider.

We shall also require NGDCs to adjust their PGC gas cost monthly, instead of quarterly. We have noted that under the present approach the NGDC gas price does not reflect actual market fluctuations which may be due to changes in weather, the seasons and other factors. *Action Plan* at 16. As a result, it operates as an impediment to making valid comparisons between offers from NGSs and NGDCs. In order for the PTC to become a meaningful price indicator, it must be adjusted on a timely basis. Monthly adjustments should accomplish this. Therefore, we will suspend and waive the requirement in 52 Pa. Code § 53.64(i)(5) that the PGC be adjusted quarterly and require that it be adjusted on a monthly basis.

This waiver shall be effective for a period of three years from the date each NGDC files rates in its first proceeding under 66 Pa. C.S. § 1307(f) after this rule becomes effective. Two years after the rule becomes effective, the Commission shall conduct a review of the retail markets in order to gauge the success of the waiver. This will also allow time to take appropriate action based upon the results of that review before the waiver expires.

2. Purchase of Receivables

NGS commentators have stated that the use of purchase of receivables (POR) "programs can promote efficiencies, reduce costs to consumers and reduce barriers to market entry by alternative natural gas suppliers." *Action Plan* at 17. Some Pennsylvania utilities have POR programs now.[3] Moreover, we have recently adopted

[3] Columbia Gas of Pennsylvania, PECO Energy Company and Duquesne Light Company.

interim guidelines for voluntary POR programs.[4] The guidelines were drafted to be consistent with the law and the Commission's policy to promote the use of POR programs to increase supplier participation in the retail natural gas supply market.

We are now proposing regulations at section 62.224 to make permanent rules for the establishment of POR programs. We have substantially adopted the interim guidelines with a few modifications. The programs appear to have worked well for those utilities that are using them now and we are aware it will be some time before these rules reach final approval. As new programs come on line through the guidelines the industry will gain new experience. If need be, we can modify these proposed rules as we find appropriate.

Under the rules, we will require the NGDCs and NGSs to negotiate the parameters of any discount arrangements. We are not going to impose such strictures at this time. Additionally, we will allow NGDCs which agree to share their gains or losses with their customers to include losses, after an appropriate period of time, as part of their uncollectible expense when they next file a base rate case. In the *Action Plan* order, we recognized that POR programs can be beneficial for NGSs and their customers. *Action Plan* at 11-13. The efficiencies created by such programs can be helpful for NGDCs too. Moreover, we are proposing to allow NGDCs to share losses and gains from these programs with their customers. This will make the benefits of the POR programs evident to all participants.

In a departure from the interim guidelines, we will not require NGSs participating in POR programs to use only NGDC consolidated billing services. By forcing NGSs to use the utility's billing system we forbid them to build other non-supply value added services into the billing program. This could have the effect of stifling innovative products such as demand response, efficiency or green products. Moreover, we are not convinced that more advanced supply products can be billed through existing NGDC billing systems. If that is so, it could stifle innovative supply products.

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4 *Establishment of Interim Guidelines for Purchase of Receivables (POR) Programs,* Docket Nos. Docket No. M-2008-2068982 and I-00040103F0002, Order entered December 19, 2008.

3. Mandatory Capacity Assignment

We have noted in our *Action Plan* that it might be helpful to the development of the retail markets if the ability of NGDCs to control their capacity on interstate natural gas pipelines were not as strong. *Action Plan* at 18-20. We also were aware that such a change would require a change in the existing law found at 66 Pa. C.S. § 2204(d)-(f). *Id.* Until such a change is made, we have decided to formalize our regulations in harmony with the existing law in order to give both NGDCs and NGSs some guidance and to ensure that requirements that the release, assignment or transfer of capacity by a NGDC shall be on a nondiscriminatory basis and shall be at the applicable contract rate for such capacity. This regulation will be found at section 62.225.

4. NGDC Costs of Competition Related Activities

In our *Action Plan*, we concluded that the NGDCs "should be able to recover *reasonable* costs that are *prudently* incurred in connection with the implementation of any changes designed to promote the development of effective competition in the retail market." *Action Plan* at 21. Such costs also include expenses associated with increasing customer participation in the market such as modifications to NGDC billing systems or increased consumer education activities. *Id.* We determined that we would allow NGDCs to recover these costs through a surcharge with an automatic adjustment mechanism. We are adopting such a mechanism today at section 62.226.
However, we note that to the extent it helps promote competition, the surcharge for competition related activities benefits all customers and, therefore, it should be paid by all customers, shoppers and non-shoppers alike. Because of that, this surcharge should not be considered in the calculation of the price to compare.

5. Regulatory Assessments

We are also creating a surcharge (Section 62.227) to allow NGDCs to recover the cost of their annual regulatory assessments to fund the Commission, Office of Consumer Advocate and Office of Small Business Advocate. *See*, 66 Pa. C.S. § 510, 71 P.S. § 309-4 and 73 P.S. § 399.46. The surcharge would be calculated and adjusted annually. This is similar to how NGDCs recover the state taxes they pay each year. Insofar as the costs of the annual assessments have been collected in base rates in the past, we are directing that the effect of those costs be removed from base rates until such time as the NGDC again files a rate case under 66 Pa. C.S. § 1308(d).[5]

Insofar as all customers have paid these costs in the past, all customers should continue to pay them through the new surcharge. Therefore, it is to be applied to shoppers, non-shoppers and all classes of customers alike. Because of that, this surcharge should not be considered in the calculation of the price to compare.

As we stated in the *Action Plan*:

> The Commission is very much aware of consumer concerns about a company's recovery of costs outside of a base rate case. However, the establishment of a surcharge with an automatic adjustment clause that allows for the timely recovery of regulatory assessments which will include costs of the Commission actions to promote and facilitate natural gas competition can be a fair and efficient means to recover costs from stakeholders.

Action Plan at 23.

ACCORDINGLY, under section 501 of the Public Utility Code, 66 Pa. C.S. §501, and the Commonwealth Documents Law, Act of July 31, 1968, P.L. 769, *as amended*, .45 P.S. §§1201, *et seq.,* and regulations promulgated thereunder at 1 Pa. Code

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[5] We are making such a requirement for all costs which had been embed in base rates, but will now be collected through a surcharge mechanism as a result of this order.

§§7.1-7.4, we add the regulations at 52 Pa. Code §§62.221-62.227 as noted above and as set forth in Annex A; **THEREFORE,**

IT IS ORDERED:

1. That the proposed rulemaking at the above-captioned docket will consider the regulations set forth in Annex A.

2. That the Secretary shall submit this Order and Annex A to the Office of Attorney General for review as to form and legality and to the Governor's Budget Office for review of fiscal impact.

3. That the Secretary shall submit this Order and Annex A for review and comment to the Independent Regulatory Review Commission and Legislative Standing Committees.

4. That the Secretary shall certify this Order and Annex A, and deposit them with the Legislative Reference Bureau to be published in the *Pennsylvania Bulletin.*

5. That an original and 15 copies of any comments referencing the docket number of the proposed regulations be submitted within 45 days of publication in the *Pennsylvania Bulletin* to the Pennsylvania Public Utility Commission, Attn: Secretary, P.O. Box 3265, Harrisburg, PA 17105-3265.

6. That the contact person for this rulemaking is Assistant Counsel Lawrence F. Barth, Law Bureau (717) 772-8579, lbarth@state.pa.us.

7. That a copy of this Order and Annex A shall be served upon the Energy Association of Pennsylvania, all jurisdictional natural gas utilities, the Office of Trial Staff, the Office of Consumer Advocate, and the Office of Small Business Advocate.

BY THE COMMISSION

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: March 26, 2009

ORDER ENTERED: MAR 2 7 2009

Annex A
TITLE 52. PUBLIC UTILITIES
PART I. PUBLIC UTILITY COMMISSION
Subpart C. FIXED SERVICE UTILITIES
CHAPTER 62. NATURAL GAS SUPPLY CUSTOMER CHOICE
Subchapter G. NATURAL GAS DISTRIBUTION COMPANIES AND COMPETITION

§ 62.221. Purpose. To foster a competitive retail marketplace for natural gas service to residential and small commercial customers, it is essential that consumers be able to compare the price of gas purchased from their incumbent NGDCs with that offered for sale by NGSs. This subchapter sets forth a number of regulatory changes which will provide a more level playing field between NGDCs and NGSs and, therefore, promote competition for natural gas supplies.

§ 62.222. Definitions

The following words and terms, when used in this subchapter, have the following meanings, unless the context clearly indicates otherwise:

Act -- The Natural Gas Choice and Competition Act (66 Pa.C.S. §§ 2201 -- 2212).

GPC -- Gas procurement charge -- A mechanism by which the effect of natural gas procurement costs removed from an NGDC's base rates are recovered.

GPRR -- Gas procurement reduction rate -- An equal offsetting credit to the GPC, billed to all residential and small commercial customers.

NGDC -- Natural gas distribution company -- As defined in § 2202 of the act (relating to definitions).

NGPA -- Net gas procurement adjustment -- A tariff rider designed to create a rate neutral adjustment to currently existing base rates and the PGC rate to develop a reasonable PTC by shifting SOLR costs related to procurement from the base rate cost of distribution to the PTC.

NGS -- Natural gas supplier -- As defined in § 2202 of the act.

Natural gas supply service -- The provision of natural gas to end users as defined at 52

Pa. Code § 62.72 (relating to customer information disclosure).

PGC -- Purchase gas cost -- Natural gas costs which are collected, with adjustments, by NGDCs from their customers pursuant to 66 Pa. C.S. § 1307(f) (relating to recovery natural gas costs).

POR -- Purchase of receivables -- Program by which an NGDC purchases the accounts receivable of NGSs.

PTC -- Price to compare -- A line item that appears on a retail customer's monthly bill for SOLR service. The PTC is equal to the sum of all unbundled natural gas costs and natural gas procurement costs-related charges to a default service customer for that month of service.

SOLR -- Supplier of last resort -- A supplier approved by the Commission under section 2207(a) of the act (relating to obligation to serve) to provide natural gas supply services to customers:

(i) Who contracted for natural gas that was not delivered.

(ii) Who did not select an alternative NGS.

(iii) Who are not eligible to obtain competitive natural gas supply.

(iv) Who return to the supplier of last resort after having obtained competitive natural gas supply.

Small business customer -- As defined at 52 Pa. Code § 62.72.

§ 62.223. Price to compare.

(a) A NGDC shall establish a GPC. The GPC shall be added to the cost of supply rate developed under 66 Pa. C.S. §1307(f) (relating to recovery of natural gas costs) to create a comparable PTC. The GPC shall be adjusted and reconciled annually in conjunction with the 1307(f) process to become effective with new PGC rates.

(b) A NGDC shall remove all natural gas procurement costs from its base rates as part of its next filing under 66 Pa. C.S. § 1308(d) (relating to general rate increases).

The expenses shall be recovered through a separate GPC surcharge. The NGDC shall include a proposed tariff rider to establish a GPC within the requirements of 66 Pa. C.S. §1307 (relating to sliding scale of rates; adjustments).

(c) A NGDC, in its next purchased gas cost filing under 66 Pa. C.S. § 1307(f), shall submit a proposed tariff rider to establish a NGPA within the requirements of 66 Pa. C.S. §1307.

(d) The NGPA shall be designed to create a rate neutral adjustment to currently existing base rates and the PGC rate to develop a reasonable PTC by shifting SOLR costs related to procurement from the base rate cost of distribution to the PTC.

(e) The proposed NGPA tariff rider shall establish a GPC on a per MCF/DTH basis to be applied to customers' bills receiving SOLR service for the recovery of gas procurement costs currently recovered through base rates, and a GPRR on a per MCF/DTH basis, as an equal offsetting credit to the GPC, billed to all residential and small commercial customers.

(f) The GPC and NGPA riders shall identify:

(1) How the surcharge will be calculated.

(2) Which costs will be recovered through the surcharge by:

(i) Customer class and cost category

(ii) FERC account number including the specific sub-accounts used to recover eligible procurement costs.

(g) The NGPA rider shall remain in effect until establishment of new base rates and a PGC rider following a base rate proceeding under 66 Pa. C.S. § 1308(d).

(h) The GPC shall be adjusted monthly.

(i) The GPC shall be subject to audit.

(j) A NGDC shall adjust its PGC monthly.

§ 62.224. Purchase of receivables programs.

(a) *Program design.*

(1) A NGDC may purchase accounts receivable from licensed NGSs which operate on the NGDC system and who wish to sell the receivables.

(2) A NGDC may purchase receivables associated with natural gas supply service charges and may not purchase other receivables that may be incurred by NGSs. The NGS shall certify that charges do not include receivables for any other products or services.

(3) A NGDC may voluntarily purchase NGS accounts receivable at a discount to recover incremental costs associated with POR program development, implementation and administration.

(4) When a NGDC chooses to purchase accounts receivable at a discount, it shall negotiate the discount rate with the NGS on its distribution system.

(i) It shall give fair notice to the NGSs of the time and place of negotiation.

(ii) It shall apply the same discount rate to all accounts receivable it purchases on its system.

(iii) It shall renegotiate the discount rate not less than once every 5 years.

(5) POR programs shall include only receivables on residential and small business customer accounts.

(6) When a NGDC purchases accounts receivable from a NGS through a Commission-approved POR program and the accounts receivable are comprised only of charges for basic natural gas supply, the NGDC may terminate service to customers for failure to pay NGS supply charges.

(7) To ensure that a NGDC's affiliated suppliers do not receive an advantage over non-affiliated suppliers, a POR program must be designed and implemented in accordance with 52 Pa. Code §§ 62.141 - § 62.142. (relating to standards of conduct).

(8) A NGDC POR program shall be included in a supplier coordination tariff, as defined by Commission rules, regulations and orders, and approved by the Commission prior to implementation.

(9) A NGDC may include the difference between its cost of the purchased receivables and the amounts it has actually collected as part of its uncollectible expense in its next base rate case when it agrees to share with its customers the losses or gains associated with POR program collections.

(10) The NGDC shall track its POR program purchases and collections.

(b) ***Customer care.***

(1) A NGS shall follow Commission regulations relating to customer service including Chapter 56 (relating to standards and billing standards), §§ 62.71-62.80 (relating to customer information disclosure), and § 62.114 (relating to standards of conduct and disclosure for licensees).

(2) A NGS shall respond to customer complaints regarding rate disputes in not more than 30 days consistent with Chapter 56 § 141 (relating to dispute procedures), § 151 (relating to general rule) and Chapter 62 § 79 (relating to complaint handling process) of the Commission regulations.

(3) A NGDC shall follow Chapter 14 of the Public Utility Code (relating to responsible utility customer protection) and Chapter 56 of Commission

regulations when terminating service to a customer for failure to pay NGS natural gas supply charges purchased under the POR program.

(4) Reconnection of service to NGS customers following termination must be made in accordance with provisions of Chapter 14 of the Code and applicable Chapter 56 regulations.

(5) A NGDC shall agree to inform all customers that service may be terminated for failure to pay NGS supply charges by a separate bill insert that specifically describes the policy for termination of service.

(6) An enrollment letter issued by a NGDC at the time of selection of the NGS shall inform customers that service may be terminated for failure to pay NGS supply charges.

(c) ***Satisfaction of the security requirements for licensing.*** A NGS's accounts receivable may be used to satisfy in full or in part the security required for licensing as a natural gas supplier.

§ 62.225. Release, assignment or transfer of capacity.

(a) A NGDC holding contracts for firm storage or transportation capacity, including gas supply contracts with Pennsylvania producers, or a city natural gas distribution operation, may release, assign or transfer the capacity or Pennsylvania supply, in whole or in part, associated with those contracts to licensed NGSs or large commercial or industrial customers on its system.

(1) A release, assignment or transfer shall be made on a nondiscriminatory basis.

(2) A release, assignment or transfer shall be at the applicable contract rate for capacity or Pennsylvania supply and shall be subject to applicable contractual arrangements and tariffs.

(3) The amount released, assigned or transferred shall be sufficient to serve the level of the customers' requirements for which the NGDC has procured the capacity determined in accordance with the NGDC's tariff or procedures approved in its restructuring proceedings.

§ 62.226. Natural gas distribution company costs of competition related activities.

(a) As part of its next annual filing pursuant to 66 Pa. C.S. § 1307(f), a NGDC may include a proposed tariff rider to establish a nonbypassable reconcilable surcharge filed within the requirements of 66 Pa. C.S. § 1307 designed to recover the reasonable and prudently incurred costs of implementing and promoting natural gas competition within the Commonwealth.

(b) The surcharge shall be calculated annually and adjusted to account for past over- or under-collections in conjunction with the 1307(f) process to become effective with new PGC rates.

(c) The surcharge shall be recovered on a per unit basis on each unit of commodity which is sold or transported over its distribution system without regard to the customer class of the end user.

(d) Before instituting the surcharge, a NGDC shall remove the amounts attributable to promoting retail competition from its base rates. This may be done through a 66 Pa. C.S. § 1308 (relating to voluntary changes in rates) rate case filed not less than

5 years after first seeking recovery through a 66 Pa. C.S. § 1307 nonbypassable mechanism.

(e) Until a NGDC which seeks a nonbypassable recovery of its costs of promoting retail competition files a base rate case under 66 Pa. C.S. § 1308(d), the NGDC shall eliminate the effect of recovery of these costs in base rates though the filing of a credit to its base rates equal to the amount in base rates. This may be established through the filing of a fully allocated cost of service study and a proposed tariff rider in the NGDC's proceeding under 66 Pa. C.S. § 1307(f) to establish a revenue neutral adjustment clause to credit base rates for the costs associated with promoting retail competition that are currently reflected in base rates and to recover fully those costs through a nonbypassable reconcilable surcharge. The credit and surcharge shall be adjusted not less than annually through the 66 Pa. C.S. § 1307(f) process.

(f) The revenue neutral adjustment clause rider shall remain in effect until establishment of new base rates under 66 Pa. C.S. § 1308(d) which include a fully allocated cost of service study to remove these costs from base rates.

(g) The surcharge shall be subject to audit.

§ 62.227. Regulatory assessments.

(a) As part of its next annual filing pursuant to 66 Pa. C.S. § 1307(f), a NGDC shall include a proposed tariff rider to establish a nonbypassable reconcilable surcharge filed within the requirements of 66 Pa. C.S. § 1307 designed to recover the NGDC regulatory assessment payments made pursuant to 66 Pa. C.S. § 510 (relating to assessment for regulatory expenses upon public utilities).

(b) The surcharge shall be calculated annually and shall include costs associated with regulatory assessments for the Public Utility Commission at 66 Pa. C.S. § 510, the Office of Consumer Advocate at 71 P.S. § 309-4.1 (relating to assessment upon public utilities, disposition, appropriation and disbursement of such assessments), and the Office of Small Business Advocate at 73 P.S. § 399.46 (relating to assessment upon public utilities; disposition, appropriation and disbursement of such assessments). The NGDC shall include in its annual filing:

(1) Copies of its most recent annual bills for the Commission for each assessment.

(2) Copies of adjusted bills or refunds received since its prior filing.

(3) Proof of payment of each bill.

(c) The surcharge shall be recovered on a per unit basis on each unit of commodity which is sold or transported over its distribution system without regard to the customer class of the end user.

(d) The surcharge shall be adjusted annually to account for past over- or under-collections in conjunction with the 1307(f) process to become effective with new PGC rates.

(e) Before instituting the surcharge, a NGDC shall remove the amounts attributable to the regulatory assessments from its base rates. This may be done through a 66 Pa. C.S. § 1308 rate case filed not less than 5 years after first seeking recovery through a 66 Pa. C.S. § 1307 nonbypassable mechanism.

(f) Until a NGDC which seeks a nonbypassable recovery of its regulatory assessments files a base rate case under 66 Pa. C.S. § 1308(d), the NGDC shall eliminate the effect of recovery of assessment payments in base rates though the filing of a credit to its base rates equal to the amount of assessment costs in base rates. This may be established through a fully allocated cost of service study and a proposed tariff rider in the NGDC's next proceeding under 66 Pa. C.S. § 1307(f) to establish a revenue neutral adjustment clause to credit base rates for the assessment costs reflected in rates and to recover fully those assessment costs through a nonbypassable reconcilable surcharge. The credit and surcharge shall be adjusted not less than annually through the 66 Pa. C.S. § 1307(f) process.

(g) The revenue neutral adjustment clause rider shall remain in effect until establishment of new base rates under 66 Pa. C.S. § 1308(d) which include a fully allocated cost of service study to remove these costs from base rates.

(h) The surcharge shall be subject to audit.

PENNSYLVANIA PUBLIC UTILITY COMMISSION
Harrisburg, Pennsylvania 17105-3265

Re: Natural Gas Distribution Companies and the Promotion of Competitive Retail Markets

Public Meeting: March 26, 2009
2069114-LAW
Docket No. L-2008-2069114

STATEMENT OF CHAIRMAN CAWLEY

The *Natural Gas Choice and Competition Act,* 66 Pa. C.S. §2201-12 (Competition Act), was enacted by the Legislature in 1999 with the purpose of restructuring the natural gas industry to allow the retail sale of natural gas in an open market. Based upon our experience to date, this Commission is initiating a rulemaking proceeding to adopt regulations governing the relationships between Natural Gas Distribution Companies (NGDCs) and the Natural Gas Suppliers (NGSs) which sell, or seek to sell, natural gas to end users on the NGDCs' distribution systems. This rulemaking is being initiated to comply with the Legislature's directive to ensure that consumers of natural gas will be able to shop for gas that is marketed on a level playing field for all market participants.

As part of this rulemaking, we are advancing some relatively broad provisions with regard to capacity release. Being very broad, these regulations may not be sufficiently specific to address every alleged inequity in the allocation of upstream transportation and storage capacity and the costs of this capacity assigned to NGSs that assume the firm service obligations of their retail customers. For this reason, I strongly encourage NGSs that regard existing release capacity provisions in NGDC tariffs as a barrier to retail natural gas competition (1) to provide specific examples of these barriers in the Pennsylvania retail market, and (2) to suggest alternative regulatory language (to that set forth in Annex A to the Commission's Order) that would resolve these barriers within the bounds of existing legislation, and that would reasonably accommodate the operational constraints of NGDCs.

March 26, 2009

James H. Cawley

James H. Cawley
Chairman

PENNSYLVANIA PUBLIC UTILITY COMMISSION
Harrisburg, Pennsylvania 17105-3265

Natural Gas Distribution Companies And the Promotion of Competitive Retail Markets

Public Meeting – March 26, 2009
2069114-LAW
Docket No: L-2008-2069114

STATEMENT OF VICE CHAIRMAN TYRONE J. CHRISTY

Before the Commission for consideration is the initiation of a proposed rulemaking proceeding to promulgate regulations that are designed to encourage increased natural gas supply competition among our jurisdictional Natural Gas Distribution Companies (NGDCs) and licensed Natural Gas Suppliers (NGSs). The genesis of this rulemaking is the Commission's *Report to the General Assembly on Pennsylvania's Retail Natural Gas Supply Market* that was released in October 2005. In that report, the Commission determined that effective competition did not exist in Pennsylvania's retail natural gas market, and reconvened the stakeholders in the natural gas industry to identify existing barriers to competition. In our SEARCH Final Order and Action Plan issued on September 11, 2008, the Commission identified several initiatives to eliminate these barriers to competition. The rulemaking before us today, which addresses five specific issues regarding the NGDCs, is the first of these pre-identified initiatives.

I have some specific concerns with certain aspects of this proposed rulemaking that I request parties to consider addressing in their comments, which are due within 45 days of publication in the *Pennsylvania Bulletin.* First, with regard to the Price to Compare, the proposed rulemaking intends to remove natural gas procurement related costs from NGDC base rates and include them within the Price to Compare. The amount of these embedded gas procurement costs would be determined in individual NGDC proceedings held in conjunction with the first purchased gas cost proceeding after the regulations become final. At this time, the Commission is not attempting to identify every individual gas cost that should be removed from base rates. These costs likely will vary from NGDC to NGDC and it may be difficult to reach consensus on this issue. Also, if these costs are not avoidable and are included within the Price to Compare, then they may not be recovered by the NGDCs, potentially resulting in stranded costs. Under this scenario, consumers of the NGDCs who choose not to shop will be paying higher costs to support those customers who do choose to shop.

Furthermore, once the amount of these costs are identified and included within the Price to Compare, the proposed regulations require NGDCs to adjust their Price to Compare on a monthly basis, instead of quarterly. The alleged purpose of the monthly adjustment requirement is that the present approach does not reflect actual market prices and does not allow for meaningful price comparisons between offers from NGSs and the NGDC Price to Compare.

I am inclined to disagree with the proposed requirement to implement monthly NGDC pricing as I question whether it is sound public policy to make SOLR service volatile or "ugly" simply to encourage fixed price offers from competitive natural gas suppliers. I believe that the existing quarterly adjustment process represents a fair compromise between annual and monthly adjustments and should be retained. This allows natural gas consumers to have some period of stability in their gas costs.

However, I have an overriding concern regarding the entire Price to Compare concept, whether it will be adjusted quarterly or monthly. Today, when natural gas customers decide to switch to an alternative supplier, many of these customers have no idea if the offered price will continue to be more attractive than the NGDC's Price to Compare. Simply providing the currently effective Price to Compare does not allow consumers to make informed decisions when considering offers from competitive suppliers. More information is necessary, especially if natural gas customers are exposed to NGS proposals which require a long term commitment. Consumers need to be provided projected natural gas price forecasts to make informed, educated choices. I request that commenters address whether the Commission should develop a monthly projection of natural gas prices for the ensuing twelve months based upon the best available market information. This information could be posted on our website and the Commission could require each NGDC to provide this information to its customers on a regular basis. Without this type of information being readily available, consumers will be unaware if the choice they are making today will continue to be the right choice two, four or six months down the road.

Natural gas consumers need to be informed as much as possible in order to make reasoned decisions if the competitive gas market is to succeed. In my opinion, the development of gas price forecasts will help reduce the number of cases where marketers take advantage of uninformed consumers with price offers that in reality cost consumers more than if they simply not had shopped. These gas price forecasts are readily available and should be made available to all natural gas customers.

Another area of concern is the currently effective migration riders, which are not made easily available to consumers. Again, without the knowledge of what it will cost a customer to switch to an alternative supplier, that customer is literally gambling as to what decision to make.

Therefore, I request that commenters address my proposal, or offer other proposals that would better educate and inform Pennsylvania consumers. Because of my disagreement with the proposed monthly adjustments, I will concur in the result only of this proceeding for the purpose of seeking comments from interested parties.

3-26-09
DATE

Tyrone J Christy
TYRONE J. CHRISTY, VICE CHAIRMAN

ATTACHMENTS RE
NO. 14 OF THE
REGULATORY ANALYSIS FORM

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA. 17105-3265

Public Meeting Held October 6, 2005

Commissioners Present:
Wendell F. Holland, Chairman
James Cawley, Vice Chairman
Kim Pizzingrilli, Statement attached
Terrance J. Fitzpatrick
Bill Shane, Concurring & Dissenting in part – Statement attached

Investigation into the Natural Gas Supply Market: Report to the General Assembly On Competition In Pennsylvania's Retail Natural Gas Supply Market — Docket No. I-00040103

INVESTIGATORY ORDER AND REPORT TO THE GENERAL ASSEMBLY

BY THE COMMISSION:

In accordance with Section 2204(g) of the Public Utility Code, 66 Pa. C.S. §2204(g), by Order entered May 28, 2004 at Docket No. I-00040103, the Pennsylvania Public Utility Commission ("Commission") initiated an investigation into competition in Pennsylvania's retail natural gas supply market. Section 2204(g) directs the Commission to investigate and evaluate Pennsylvania's retail natural gas supply market to assess the resulting level of competition five years after the effective date of the "Natural Gas Choice and Competition Act" ("Act"). Section 2204(g) also directs the Commission to report its findings to the General Assembly. If the Commission determines that "effective competition" does not exist, the Commission is required to reconvene the stakeholders in the natural gas industry "to explore avenues, including legislative, for encouraging increased competition in this Commonwealth." 66 Pa. C.S. §2204(g). With this Order, the Commission is (1) issuing its *Report to the General Assembly on Competition in Pennsylvania's Retail Natural Gas Supply Market* finding that "effective competition" in the retail natural gas supply services market does not exist on a statewide basis; (2) directing the Stakeholders to convene to consider means to increase competition in the retail natural gas market statewide; and (3) closing this investigation docket.

DISCUSSION

Procedural History

On May 28, 2004, the Commission initiated an investigation into the effectiveness of competition in the natural gas industry. In its Order the Commission directed natural gas distribution companies ("NGDCs") and natural gas suppliers ("NGSs") to file specific data relating to the natural gas market. Also, the PUC invited other interested parties to provide comments or written testimony addressing topics that are relevant in assessing the level of competition in that market. Twenty-four commenters,[1] including one pipeline company,[2] filed comments.

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[1] Office of Consumer Advocate, Office of Small Business Advocate, Energy Association of Pennsylvania, the Mack Service Group, Equitable Gas Company ("Equitable"), Columbia of Pennsylvania, Independent Oil and Gas Association ("IOGA"), NRG Energy Center Pittsburgh ("NRG"), Constellation New Energy – Gas Division ("New Energy"), Amerada Hess Corporation ("Amerada Hess"), PEPCO Energy Services; Interstate Gas Supply Inc. ("Interstate Gas Supply"); Natural Fuel Resources, Inc. ("NRG"), UGI Utilities, Inc. – Gas Division ("UGI"); Peoples Natural Gas Co ("Dominion Peoples"); Texas Eastern Transmission, Inc. ("Texas Eastern"); Shipley Energy Company ("Shipley"); Dominion Retail, Inc. ("Dominion Retail"); National Energy Marketers Association; Agway Energy Services; PEPCO Energy Services; Utilitech, Inc.; Shell Energy Company ("Shell Energy"); and Direct Energy Services ("Direct Energy").

[2] Texas Eastern.

Responses to data requests were filed by all of the NGDCs.[3] Nineteen licensed NGSs[4] filed responses to the Commission's questions.

The PUC held an *en banc* hearing on September 30, 2004 to further explore the level of competition in Pennsylvania. Ten witnesses[5] representing the Energy Association of Pennsylvania ("EAP"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), and various NGSs testified at the hearing. Representatives from the NGDCs did not present testimony but were available to be questioned by the Commissioners. Reply comments were permitted to be filed by October 12, 2004. Nine reply comments were filed.[6]

Report to the General Assembly

After extensive review of the record evidence presented in this investigation, the Commission has prepared the instant report for delivery to the General Assembly, and public release[7].

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[3] The NGDCs filing responsive data include natural gas distribution companies with annual operating income greater than $6,000,000, 66 Pa. C.S. §2202, and the Philadelphia Gas Works.

[4] NGSs are defined at 66 Pa. C.S. §2202 to include entities other than NGDCs that provide natural gas supply service to retail gas customers utilizing the jurisdictional facilities of the NGDC. The number of suppliers varies as suppliers enter and exit the market. As of September 30, 2004, there were 82 licensed NGSs in Pennsylvania.

[5] Witnesses testifying at the hearing represented EAP, Amerada Hess, Direct Energy, Dominion Retail, Interstate Gas, Shell Energy, Shipley, NRG, OCA and OSBA.

[6] EAP; T.W. Phillips, Inc.; New Energy; Industrial Energy Customers of Pennsylvania; OSBA; Dominion Peoples; Equitable; and Amerada Hess filed separate comments. Joint Comments were filed by Direct Energy, Dominion Retail, Interstate Gas, Shell Energy, and Shipley Energy.

[7] The report is incorporated by reference into this order.

It is the Commission's judgment that the existence of "effective competition" in the retail natural gas supply[8] market in Pennsylvania would be demonstrated by participation in the market by many buyers and sellers, the lack of substantial barriers to market entry for suppliers, the lack of substantial barriers that would discourage customer participation, and the presence of sellers offering buyers a variety of products and services. Based on this standard and the record in this proceeding, there is not "effective competition" in the retail natural gas supply market on a statewide basis at this time. The Commission's competitive assessment is based on its findings, which are summarized as follows:

(1) The record demonstrates a lack of participation by natural gas suppliers and buyers in the retail natural gas supply services market on a statewide basis.

(2) The record indicates that natural gas distribution companies tend to act as price leaders in their respective service territories because many customers are not aware that that the commodity price of natural gas, i.e., the "Price to Compare" or "PTC," is a quarterly reconcilable price, based on projections, rather than a fixed annual price.

(3) According to suppliers, substantial barriers to entry in the retail natural gas supply market exist because of differing security requirements among natural gas distribution companies.

(4) According to suppliers, substantial barriers to entry and continued participation by natural gas suppliers in the retail natural gas service supply market exist as the result of the omission of procurement, administrative and other costs from the natural gas distribution company's commodity price of natural gas, i.e., the "Price to Compare" or the "PTC."

(5) According to suppliers, substantial barriers to supplier participation in the retail natural gas supply market exist because of penalties placed on suppliers that vary among natural gas distribution company systems and that are not cost-based.

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[8] The term "Natural Gas Supply Services" is defined at 66 Pa. C.S. §2202 as including "(i) the sale or arrangement of the sale natural gas to retail gas customers; and (ii) services that may be unbundled by the commission under section 2203(3)(relating to standards for restructuring of natural gas utility industry."

(6) The regulatory lag in establishing and implementing quarterly price adjustments by natural gas distribution companies tends to mask the current market price of natural gas.

(7) The marketplace lacks accurate and timely price signals; as a result, the market cost of natural gas supply service offered by natural gas distribution companies is not communicated immediately to customers.

In light of the above findings and conclusion the Commission directs, pursuant to its authority at 66 Pa. C.S. §2204(g), that the stakeholder group in the natural gas industry convene to explore avenues, including legislative (if appropriate), for increasing competition in Pennsylvania's retail natural gas supply service market. The Stakeholders shall examine the issues discussed in the report and other matters that are relevant to the retail natural gas supply service competitive market, and develop recommendations regarding changes that need to be made to the market structure and operation. Also, the stakeholders shall recommend any amendments that need to be made to the "Natural Gas Choice and Competition Act" and the Public Utility Code and revisions to the Commission regulations that would enhance competition.

The Commission will issue a Secretarial Letter announcing the date for this meeting and soliciting comments for a proposed agenda. We anticipate that the first stakeholders meeting will be held before the end of 2005;

THEREFORE,

IT IS ORDERED:

1. That the *Report to the General Assembly on Competition in Pennsylvania's Retail Natural Gas Supply Market* (*Report*) is adopted and issued for public release.

2. That the Secretary shall cause a copy of this Order and the *Report* to the be delivered to the Chief Clerks of the House of Representatives and the Senate of Pennsylvania, the Chairman of the Senate Consumer Protection and Professional Licensure Committee, the Chairman of the House Consumer Affairs Committee and the Governor.

3. That the Secretary shall serve a copy of this Order and the *Report* to the Office of Consumer Advocate, the Office of Small Business Advocate, the Energy Association of Pennsylvania, all jurisdictional natural gas distribution companies, all licensed natural gas suppliers, and all other participants to this investigation.

4. That a copy of this Order and the *Report* shall be posted to the Commission Internet site at http://www.puc.state.pa.us .

5. That the Natural Gas Stakeholders shall convene to begin to examine avenues, including legislative, to increase competition in the retail natural gas supply services market before the end of 2005.

6. That the docket for this investigation be closed.

BY THE COMMISSION:

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: October 6, 2005

ORDER ENTERED: October 6, 2005

Report to the General Assembly on Competition in Pennsylvania's Retail Natural Gas Supply Market

From the
Investigation into the Natural Gas Supply Market,
Docket No. I-00040103

October 2005

PENNSYLVANIA
PUC
PUBLIC UTILITY COMMISSION

TABLE OF CONTENTS

I. EXECUTIVE SUMMARY

In accordance with Section 2204(g) of the Public Utility Code, 66 Pa. C.S. §2204(g), by Order entered May 28, 2004 at Docket No. I-00040103, the Pennsylvania Public Utility Commission ("Commission") initiated an investigation into competition in Pennsylvania's retail natural gas supply market. Section 2204(g) directs the Commission to investigate and evaluate the retail natural gas supply market as restructured under "The Natural Gas Choice and Competition Act" to assess the resulting level of competition five years after the effective date of the Act. Section 2204(g) also directs the Commission to report its findings to the General Assembly. Section 2204(g) further directs the Commission, if it determines that "effective competition" does not exist, to reconvene the stakeholders in the natural gas industry "to explore avenues, including legislative, for encouraging increased competition in this Commonwealth." 66 Pa. C.S. §2204(g).

In the Commission's judgment, the existence of "effective competition" in the retail natural gas supply[1] market in Pennsylvania would be demonstrated by participation in the market by many buyers and sellers, the lack of substantial barriers to market entry for suppliers, the lack of substantial barriers that would discourage customer participation, and the presence of sellers offering buyers a variety of products and services. Based on this standard and the record in this proceeding[2], there is not effective competition in the retail natural gas supply market on a statewide basis at this time. The Commission's competitive outlook is based on seven key conclusions:

[1] "Natural Gas Supply Services" are defined at 66 Pa. C.S. §2202 as including "(i) the sale or arrangement of the sale natural gas to retail gas customers; and (ii) services that may be unbundled by the commission under section 2203(3)(relating to standards for restructuring of natural gas utility industry."

[2] *Investigation into Competition in the Natural Gas Supply Market*, Docket No. I-00040103.

(1) The record demonstrates a lack of participation by natural gas suppliers and buyers in the retail natural gas supply services market on a statewide basis.

(2) The record indicates that natural gas distribution companies tend to act as price leaders in their respective service territories because many customers are not aware that that the commodity price of natural gas, i.e., the "Price to Compare" or "PTC," is a quarterly reconcilable price, based on projections, rather than a fixed annual price.

(3) According to suppliers, substantial barriers to entry in the retail natural gas supply market exist because of differing security requirements among natural gas distribution companies.

(4) According to suppliers, substantial barriers to entry and continued participation by natural gas suppliers in the retail natural gas service supply market exist as the result of the omission of procurement, administrative and other costs from the natural gas distribution company's commodity price of natural gas, i.e. the PTC.

(5) According to suppliers, substantial barriers to supplier participation in the retail natural gas supply market exist because of penalties placed on suppliers that vary among natural gas distribution company systems and that are not cost-based.

(6) The regulatory lag in establishing and implementing quarterly price adjustments by natural gas distribution companies tends to mask the current market price of natural gas.

(7) The marketplace lacks accurate and timely price signals; as a result, the market cost of natural gas supply service offered by natural gas distribution companies is not communicated immediately to customers.

In light of the above findings and conclusion, the Commission directs, pursuant to 66 Pa. C.S. §2204(g), that the stakeholder group in the natural gas industry reconvene to explore avenues, including legislative (if appropriate), for encouraging increased competition in Pennsylvania's retail natural gas supply service market. The collaborative shall examine the above listed issues and other matters that are relevant to the retail natural gas supply service competitive market, and develop recommendations regarding changes that need to be made to the market structure and operation. Also, the stakeholders shall recommend any amendments that need to be made to the Natural Gas Choice and Competition Act and the Public Utility Code and revisions that need to be made to Commission regulations that will enhance competition.

The Commission anticipates that the first stakeholder meeting will be held before the end of this year.

II. HISTORY OF THE PROCEEDING

Section 2204(g) of the "Natural Gas Choice and Competition Act" ("Competition Act") requires the Commission to initiate an investigation or other appropriate proceeding to determine whether effective competition for natural gas supply exists in the Commonwealth. The proceeding must be launched five years after the effective date of the Act, July 1, 1999. The statute provides for participation by all interested parties, and requires the Commission to report its findings to the General Assembly.

On May 28, 2004, the Commission entered an Order initiating an investigation into the effectiveness of competition in the natural gas industry.[3] In its order the Commission directed natural gas distribution companies ("NGDCs") and natural gas suppliers ("NGSs") to file specific data relating to the natural gas market. Also, the PUC invited other interested parties to provide comments or written testimony addressing topics that are relevant in assessing the level of competition in that market. Twenty-four commenters, including one pipeline company,[4] filed comments. The commenters included Office of Consumer Advocate ("OCA"); Office of Small Business Advocate ("OSBA"); Energy Association of Pennsylvania ("EAP"); the Mack Service Group ("Mack"); Equitable Gas Company ("Equitable"); Columbia of Pennsylvania ("Columbia"); Independent Oil and Gas Association ("IOGA"); NRG Energy Center Pittsburgh ("NRG"); Constellation New Energy –Gas Division ("New Energy"); Amerada Hess Corporation ("Amerada Hess"); PEPCO Energy Services ("PEPCO"); Interstate Gas Supply Inc. ("Interstate Gas Supply"); Natural Fuel Resources, Inc. ("NRG"); UGI Utilities, Inc. – Gas Division ("UGI"); Peoples Natural Gas Co ("Dominion Peoples"); Texas Eastern Transmission, Inc. ("Texas Eastern"); Shipley Energy Company ("Shipley"); Dominion Retail, Inc. ("Dominion Retail"); National Energy Marketers Association ("NEMA"); Agway Energy Services ("Agway"); PEPCO

[3] A copy of this order is reproduced in the Appendix to this Report.

[4] Texas Eastern Transmission, Inc.

Energy Services ("PEPCO"); Utilitech, Inc. "Utilitech"); Shell Energy Company ("Shell Energy"); and Direct Energy Services ("Direct Energy").

Responses to data requests were filed by all of the NGDCs.[5] Nineteen licensed NGSs[6] filed responses to the Commission's questions.

The PUC held an *en banc* hearing on September 30, 2004 to further explore the level of competition in Pennsylvania. Ten witnesses[7] representing the Energy Association of Pennsylvania ("EAP"), the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA"), and various NGSs testified at the hearing. Representatives from the NGDCs did not present testimony but were available to be questioned by the Commissioners.

Reply comments were permitted to be filed by October 12, 2004. Nine reply comments were filed. Reply commenters included EAP, T.W. Phillips, Inc. ("Phillips"); New Energy, Industrial Energy Customers of Pennsylvania ("IECPA"), OSBA, Dominion Peoples, Equitable, and Amerada Hess filed separate comments. Joint Comments were filed by Direct Energy, Dominion Retail, Interstate Gas, Shell Energy, and Shipley Energy.

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[5] The NGDCs filing responsive data include natural gas distribution companies with annual operating income greater than $6,000,000, 66 Pa. C.S. §2202, and the Philadelphia Gas Works.

[6] NGSs are defined at 66 Pa. C.S. §2202 to include entities other than NGDCs that provide natural gas supply service to retail gas customers utilizing the jurisdictional facilities of the NGDC. The number of suppliers varies as suppliers enter and exit the market. As of September 30, 2004, there were 82 licensed NGSs in Pennsylvania.

[7] Witnesses testifying at the hearing represented EAP, Amerada Hess, Direct Energy, Dominion Retail, Interstate Gas, Shell Energy, Shipley, NRG, OCA and OSBA.

III. INTRODUCTION

A. Section 2204(g)

Section 2204(g) of the Competition Act, 66 Pa. C.S. §2204(g), directs the Commission to investigate and evaluate the existing level of competition in the restructured natural gas supply service market five years after the Competition Act went into effect, and to report its findings to the General Assembly. If the Commission determines that "effective competition" does not exist in the market, the Commission is required to reconvene stakeholders to explore avenues, including changes to the legislation, for encouraging increased competition in this Commonwealth. The Competition Act, by not defining "effective competition," deferred to the Commission to use its expertise to define effective competition, to determine how to measure competition and to ascertain what constitutes effective competition. Accordingly, consistent with this charge, the Commission has set forth in this report the standards that it used to evaluate the effectiveness of competition in the retail natural gas supply market statewide, and its conclusions regarding the level of competition.

B. Industry Structure[8]

The natural gas industry has three segments: production, transmission and distribution. In the early 1970s, all three segments of the industry were price-regulated. The federal government, then through the Federal Power Commission ("FPC"), regulated the prices paid by interstate pipelines to producers for gas at the wellhead. The FPC also regulated interstate pipelines which transported this gas to the city gates of local natural

[8] The description of regulation of the natural gas industry was taken in part from the *UGI Comments* at pp. 4-8 and was derived from testimony presented in hearings by UGI's now retired president, Richard Bunn, before the House Consumer Affairs Committee in 1997, concerning legislation which later was enacted as the Competition Act.

gas distribution companies ("NGDCs") and sold the gas to the local gas distribution utilities at bundled rates. Finally, state utility commissions regulated bundled rates charged by the NGDCs for sales of gas at retail to end-user customers.

When federal regulation of wellhead prices proved to be unsuccessful, resulting in severe shortages of natural gas, Congress addressed these problems in several ways. In 1977, Congress reorganized the FPC into the Federal Energy Regulatory Commission ("FERC"). Congress really began the process of increasing maximum allowable natural gas prices in the late 1970s, beginning with the *Natural Gas Policy Act of 1978*, and deregulated all vintages of natural gas prices in 1989,when it passed the Wellhead Decontrol Act that removed all regulation from the gas commodity by 1993. *Natural Gas Decontrol Act of 1989*, H.R.Rep.No.101-29, 101st Cong., 1st Sess.,(1989). This deregulation greatly stimulated production.

The second segment of the natural gas industry is comprised of the federally-regulated interstate pipelines that deliver gas from the production areas to Pennsylvania's NGDCs. This segment of the natural gas industry was also restructured, but not deregulated, by federal authorities in the 1980s and 1990s. In the 1980s these pipelines were required to open their systems to transportation as an alternative to bundled city gate sales service, and in the 1990s were required, as a practical matter, to exit the so-called merchant function of making such bundled sales.[9] In 1986, the Commission adopted formal rules requiring the availability of such service on all Pennsylvania distribution systems.[10]

[9] *See* FERC Order 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 436, 50 FR 42408 (Oct. 18, 1985), FERC Stats. & Regs. [Regulations Preambles 1982-1985] 30,665 Docket Nos. RM91-11-000 and RM87-34-065, and FERC Order 636. *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations; Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, ORDER NO. 636 (April 8, 1992), [FINAL RULE], Docket Nos. RM91-11-000 and Docket No. RM87-34-065.

[10] 52 Pa. Code Ch. 60 (relating to natural gas transportation service).

Customers with varying needs for interstate pipeline transportation and storage services share the same transmission and distribution systems with smaller, space heating customers. For example, larger Commercial and Industrial ("C&I") customers with higher load factors have a flat load and utilize the same amount of gas on a relatively constant basis throughout the year. In contrast, smaller Commercial customers and residential customers have loads that fluctuate throughout the year, and usage varies on a seasonal basis.

Consequently, larger C&I customers have little need for storage services used to accommodate heating customers' seasonal swings in demand. Further, larger C&I customers may be able to use interstate pipeline capacity efficiently because they do not need to reserve and pay for pipeline capacity to meet seasonal peak demands as they have the discretion to move production schedules, supplement with alternative fuels or implement selective shut downs. Therefore, such customers may have a low unit cost for pipeline capacity under federal pricing methodologies that require payment for pipeline capacity throughout the year, regardless of whether the capacity is needed throughout the year.

The third segment of the natural gas industry is composed of NGDCs. Under the Competition Act, the NGDC segment of the industry was to remain fully regulated and largely unaffected, except that rates would be unbundled to facilitate implementation of competition by natural gas suppliers for small customers.

Today, the natural gas commodity market is a more mature market. NGDCs and NGSs (and C&I customers because of the availability of transportation service[11]) all compete to purchase natural gas supplies in the same wellhead markets at prices set by competition and the economic law of supply and demand.

[11] The increased availability of transportation service to customers is discussed *infra.* at pp. 11-13.

C. History of Competition in Natural Gas Industry

1. Competition Among Gas Companies Overlapping Service Territories

The Commission has been encouraging competition in the gas industry since the early 1980's. Commission policy favoring competition among natural gas companies with overlapping service territories[12] had its inception in cases where a customer was permitted to choose its gas company. In *Montefiore Hospital Assn. of Western Pa.*, 54 Pa. PUC 566 (1981), the Commission ruled that one gas company could serve an existing customer of another gas company where the companies' service territories overlapped.[13] This Commission "customer choice" policy passed judicial muster in *Borough of Grove City v. Pa. PUC*, 505 A.2d 346 (Pa. Cmwlth. 1986).

Two years later in *Columbia Gas of Pa. Inc. v. Carnegie Natural Gas Co.*, 61 Pa. PUC 313 (1986), the Commission advised jurisdictional natural gas utilities that it would no longer prohibit competition among natural gas utilities with overlapping service territories, and the Commission expressly revoked a 1957 policy statement that prohibited

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[12] Overlapping service territories in Western Pennsylvania resulted from the manner in which gas companies could claim service territories under the Natural Gas Company Act of 1885 (Act of May 29, 1885, P.L. 29, No. 32). To acquire a certain territory, the gas company would file a charter indicating "[t]he place or places where natural gas is intended to be mined for and produced or received, the place or places where it is to be supplied to consumers, [and] the general route of its pipe line or lines and branches. . . ." Section 2 of the *Natural Gas Companies Act of 1885*, 15 P.S. §3542. Subsequently, in Western Pennsylvania where natural gas supplies were plentiful and terrain was challenging to traverse, competing companies constructed gathering lines, transmission lines and distribution lines sometimes side by side, and therefore claimed overlapping territories under the Act. *See Equitable Gas Company v. Apollo Gas Company and Equitable Gas Company v. Carnegie Natural Gas Company*, Order entered September 5, 1990 at Docket No. C-844028; C-844035; C-844034. *See also, People's Natural Gas Co. v. American Natural Gas Co.*, 82 A. 935 (Pa. 1911); *The Peoples Natural Gas Company v. Pa. PUC*, 567 A.2d 642 (Pa. 1989).

[13] *Compare Equitable Gas Company v. Apollo Gas Company and Equitable Gas Company v. Carnegie Natural Gas Company*, Order entered September 5, 1990 at Docket No. C-844028; C-844035; C-844034 (gas company ordered to stop serving a customer located outside of the gas company's service territory's boundaries as defined by predecessor companies' charters or certificates of public convenience).

a natural gas utility from providing service to a customer of another natural gas utility without prior Commission approval.

The Commission reiterated its policy favoring competition in *Petition of Equitable Gas for Declaratory Order*, order entered August 26, 1986 at Docket No. P-850053. In its order the Commission dismissed as moot the Petition which sought Commission approval for the initiation of service by a gas company to a new customer located on the site of a building formerly served by another gas company. The Commission's policy was affirmed by Commonwealth Court in *Peoples Natural Gas Co. v. Pa. PUC*, 554 A.2d 585 (Pa. Cmwlth. 1989).

The result of this Commission policy encouraging competition in the natural gas industry was the western Pennsylvania gas wars--customer/territorial disputes that erupted among gas distribution companies with contiguous service territories. Western Pennsylvania with its overlapping gas company service territories provided a perfect arena for such competition. Participants in the gas wars included Peoples and Apollo (*Peoples Natural Gas Co. v. Apollo Gas Co.*, Docket No. C-850521); Peoples and T.W. Phillips (*Peoples Natural Gas Co. v. Pa. PUC*, 554 A.2d 585 (Pa. Cmwlth. 1989)); and Equitable and Apollo (*Equitable Gas Co. of Equitable Resources, Inc. v. Apollo Gas Co.*, Docket Nos. C-844028 and C-844035).

2. Bypass

The Commission also considered competition faced by local distribution companies from unregulated entities that sought to compete with gas companies in their own service territories. On July 10, 1987, the Pennsylvania Gas Association filed a "Petition for Issuance of a Regulation" which sought a ruling that any person or entity seeking to provide natural gas sales or transportation service must first obtain a certificate of public convenience or an order declaring that the proposed service does not require such a certificate. *P*

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such a certificate. *Petition of the Pennsylvania Gas Association for the Issuance of a Regulation Setting Forth the Conditions Precedent to the Provision of Natural Gas Sales or Transportation Services Within the Commonwealth of Pennsylvania,* 66 Pa. PUC 383 (order entered February 2, 1988 at Docket No. P-870236). This petition was filed because of the perceived threat of bypass to local distribution companies. The Commission denied the petition but did initiate an investigation into the possibility of harm to Pennsylvania ratepayers from bypass activities. *Investigation into the Bypass of Gas Utilities by Gas Suppliers,*18 Pa. B. 1295 (order entered February 25, 1988 at Docket No. I-880878). As the result of this investigation, the Commission concluded that although the bypass of gas companies by producers, interstate pipelines, or others remained a potential threat, there was no basis to compel regulation of these entities. However, the Commission determined that the issue of bypass should continue to be addressed on a case-by-case basis. *Re: Bypass of Gas Utilities by Gas Suppliers,* 70 Pa. PUC 446, 453 (order entered August 18, 1989 at Docket No. I-880078).

3. Gas Transportation

Another aspect of gas competition involves gas transportation. The benefit of a customer purchasing gas directly at the wellhead from an interstate pipeline or from a gas marketer is immediately apparent. Even with the transportation expense, the total cost is usually less than the price charged by most gas companies for sales of gas. This makes gas transportation service very attractive economically.

Pursuant to a petition filed by the Pennsylvania Gas Association for an expedited rulemaking regarding gas transportation by natural gas utilities, Docket No. P-850040, on October 16, 1986, the Commission adopted at Docket No. L-860016 uniform transportation regulations governing natural gas transportation service. These regulations, while originally promulgated to facilitate local natural gas competition in Pennsylvania, were designed to complement transportation regulations previously enacted by FERC.

However, smaller natural gas customers were prohibited from participating in gas transportation because of the minimum annual volume of MCF required to be transported. The issue of minimum levels of transportation gas was considered by the Commission in *Pa. PUC v. Peoples Natural Gas Co.*, 58 Pa. PUC 293 (1984). There the Commission directed a major distributor of natural gas to set a minimum transportation volume of 50,000 MCF per year and to permit buyers' groups of three or less. Gas transportation regulation in the Commonwealth followed the policy established in *Peoples* for a number of years. When the Commission later promulgated regulations for gas transportation service, the limit of three buyers in each buyers' group (absent gas company concurrence in a larger group size) was incorporated into those rules. 52 Pa. Code §60.3(b). However, the minimum level to qualify for transportation service was left to be established on a company-by-company basis.

On July 15, 1991, the Commission acted to further amend the transportation regulations by: (1) reducing the minimum volume of the transported natural gas to 5,000 MCF; (2) increasing the number of individual customers or buyers' groups eligible for transportation service from three to ten; and (3) requiring customers classified as Priority 1 under 52 Pa. Code §69.21(a)(1) to purchase standby sales service unless a customer can demonstrate that the facility for which it seeks to transport has adequate installed alternate fuel capability.[14]

At the federal level, FERC issued a series of orders extending its prior efforts to increase flexibility and competition in the natural gas industry. Order 637 and its follow-up orders provided for increased pipeline services in the secondary market, market segmentation and capacity release, all of which have increased the value of primary transportation. *Order No. 637, Regulation of Short-Term Natural Gas Transportation*

[14] *Minimum Threshold for Natural Gas Transportation* Service Order entered June 27, 1991at Docket No. L-890050. The regulations became effective March 20, 1992, 21 Pa. B. 5819.

Services and Regulation of Interstate Natural Gas Transportation Services, FERC Stats. & Regs. [Reg. Preambles 1996-2000] (CCH) P 31,091 (2000); *Order No. 637-A*, Order on Rehearing, *Regulation of Short-Term Natural Gas Transportation Services And Regulation of Interstate Natural Gas Transportation Services*, FERC Stats. & Regs. [Reg. Preambles 1996-2000] (CCH) P 31,099 (2000); Order No. 637-B; Order Denying Rehearing, *Regulation of Short-Term Natural Gas Transportation Services And Regulation of Interstate Natural Gas Transportation Services*, 92 FERC 61,602 (2000).

On April 8, 1992, FERC issued its Final Rule in *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations* (Docket No. RM91-11-000); and *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol* (Docket No. RM87-34-065). FERC's Order 636 essentially restructured the gas industry allowing for the unbundling of the pipelines' merchant function. Commission regulations at 52 Pa. Code Chapter 60 (relating to natural gas transportation service) were revised to be consistent with the new federal policy.[15]

4. Natural Gas Choice and Competition Act

On June 22, 1999, then Governor Thomas J. Ridge signed into law the "Natural Gas Choice and Competition Act", effective July 1, 1999, 66 Pa. C.S. §2201-§2212. The Competition Act established the Commission's role of steward of competition in Pennsylvania's retail natural gas market and allowed retail consumers in the Commonwealth to purchase natural gas supplies from independent suppliers commonly called "natural gas suppliers" while still receiving distribution services from their local natural gas distribution company. In particular, the Competition Act provides for retail natural gas consumers to choose among NGSs for natural gas supply or to receive default

[15] *Gas Transportation Tariffs*, Order entered May 13, 1996 at Docket No. L-00930084.

supply service from an NGDC, requires the licensing of suppliers, and mandates the unbundling of NGDC supply services and non-discriminatory access by suppliers to the NGDC distribution facilities. At the same time, the Act, as emphasized by EAP,[16] also requires the Commission to "ensure safety, and reliability of the natural gas and distribution service." 66 Pa. C.S. §2203(1). Accordingly, the rules for natural gas supply competition were promulgated so as not to compromise the safety and reliability of natural gas service for customers.

Beginning on November 1, 1999, retail customers had the ability to choose their natural gas supplier pursuant to the rules and regulations established by the Commission to implement the Competition Act.

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[16] EAP Comments, p. 2.

IV. EFFECTIVE COMPETITION

A. Commission Authority to Define Competition

Pursuant to Section 501(a) of the Public Utility Code, 66 Pa.C.S. §501(a), the Commission has all necessary powers to carry out the provisions and the intent of the Public Utility Code. These powers by necessity provide the Commission with the authority to define terms that appear in the Public Utility Code, but that are not defined therein, such as "effective competition."

The Courts have consistently deferred to this Commission in the interpretation of its enabling legislation unless the Commission's interpretation bears no reasonable relationship to the regulatory purpose of the legislation. *Popowsky v. Pa. PUC*, 669 A.2d 1029 (Pa. Cmwlth. 1995), *appeal granted in part*, 680 A.2d 1165 (Pa. 1995), *rev. in part*, 706 A.2d 1197 (Pa. 1997). *See also Mid-Atlantic Power Supply Association v. Pa. PUC*, 746 A.2d 1196 (Pa. Cmwlth. 2000).

Moreover, the courts have consistently recognized this Commission's authority to determine the degree of competition appropriate within any jurisdictional market. *Peoples Natural Gas Co. v. Pa. PUC*, 554 A. 2d 585 (Pa. Cmwlth. 1989). *See also, Dublin Water Company v. Pa. PUC*, 213 A. 2d 139 (Pa. Super. 1965) and *Sayre v. Pa. PUC*, 54 A. 2d 95 (Pa. Super. 1947). In other words, the courts are in agreement that the determination of the amount of competition among utilities which will best serve the public interest is a matter within the administrative discretion of the Commission. *Columbia Gas of Pennsylvania, Inc. v. Pa. PUC*, 521 A.2d 105 (Pa. Cmwlth. 1987); *Pa. PUC v. Purolator Courier*, 355 A.2d 850 (Pa. Cmwlth. 1976); *Merz White Way Tours v. Pa. PUC*, 201 A.2d 446 (Pa. Super. 1964). *See Elite Limousine v. Pa. PUC*, 832 A.2d 428 (Pa. 2003)(where the legislature provided no definition of specific criteria to grant a certificate of public convenience, the PUC could formulate its own criteria, and omit the showing of inadequacy of existing service to increase competition in motor carriers).

In the past, when the Commission has needed to define a term that had not been previously defined in the Public Utility Code or by the courts, the Commission has referred to definitions of similar terms in legislation and case law in other jurisdictions. For example, in *Application of Paper City Transfer, Inc.*, Order entered October 7, 1993, Docket No. A-00109453 F.0001, the Commission defined "destructive competition" by reference to definitions of "unfair competition" and "harmful competition" established by the courts in *Brinks, Inc. v. Pa. PUC*, 424 A.2d 1010, 1012, note 2 (Pa. Cmwlth. 1981).

The Commission has also looked to other disciplines to define certain "terms" that were necessary to its analysis in certain matters. In the *Investigation Upon the Commission's Own Motion With Regard to PJM Installed Capacity Credit Markets*, Order entered June 13, 2002 at Docket No. I-00010090, the Commission described the term "elasticity" by reference to its use in economics and mathematics in its order concluding an investigation into possible anti-competitive activity. The term "elasticity" had been used by PJM Interconnection, LLC's market monitoring unit in a report.

As previously stated, the General Assembly, by enacting the Competition Act, has determined that competition in the retail natural gas supply market is in the public interest. However, the task of defining "effective competition" was delegated to the Commission. Accordingly, it is appropriate for this Commission, as it has done in the past, to consider fundamental principles of traditional economics as well as law from other jurisdictions to formulate a workable definition of "effective competition" for use in this report.

B. General Economic Classifications of Competitive Activity

Classic economics does not provide a definition of "effective competition." However, it does provide a framework for classifying the type of competitive activity that exists within an industry. Four general categories used to describe the level of competitive activity have been identified. They are: (1) pure competition, (2) monopolistic competition, (3) oligopoly, and (4) pure monopoly.[17]

Markets where there is "pure competition" are characterized as having a large number of independent sellers producing a standardized product. Also, each seller exerts no significant control over price. New sellers have easy entrance and exit to and from the market. No significant legal, technical, or financial obstacles exist.

There are various forms of competition which are not quite "pure." These forms would exist where there are fewer than a large number of sellers; or where the product was not quite standard; or where a group of suppliers might be able to exert some control over price.

Monopolistic competition falls between pure competition and pure monopoly, but it is closer to pure competition.[18] There are a large number of sellers acting independently. Product differentiation is a major feature of monopolistic competition, and the reliability of the seller to stand behind its product is of critical importance. Customers may have specific preferences for certain sellers and small price increases will not cause them to change. Entry is a little more difficult than in the pure competition market. Considerable advertising may be necessary to inform customers of the existence

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[17] W.J. Baumol and A.S. Binder, *ECONOMICS: Principles and Policy*, (New York: Harcourt Brace Jovanovich, 1985), page 505.

[18] *Id.*

of a new entrant to the market and to convince them to switch. Because products are differentiated, competition is based on product quality, advertising, and conditions of service.

A third theoretical market structure involves oligopoly. An oligopoly's major characteristic is that a few sellers dominate the market for a product.[19] These sellers can produce standardized products or differentiated products. There may be significant obstacles to entry, and a new entrant must devote considerable resources to advertising and promotion. Oligopoly markets can be quite complex and economists identify three types[20]: (1) Collusion, (2) Price Leadership Model, and (3) Kinked-demand Model. Collusion occurs when firms attempt to control price. The Price Leadership Model features a dominant seller. The dominant seller benefits from economies of scale and could drive the other sellers out of the market by price-cutting. This seldom happens because of the dominant seller's fear of government intervention.[21] The Kinked-demand Model features several large sellers that make pricing decisions independently.

A pure monopoly is a one-seller industry. There are no substitutes available for the product. The monopoly has considerable control over price, and the barriers to market entry are quite significant.

The following table outlines the four forms of competition. It allows for a quick comparison between each.

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[19] J. Bruce Lindeman, Microeconomics Hauppauge, (New York: Barrons Educational Series, Inc., 1992), p. 101. ("Linderman")

[20] *Id.*

[21] Lindeman, *op. cit.*, p. 103.

Type of Market Structure	Number of Sellers	Nature of Product	Barriers to Entry	Examples
Perfect Competition	Many	All companies produce and sell identical products (ex. Wheat)	None	Some agricultural markets and parts of retailing come close
Monopolistic Competition	Many	Different companies produce and sell somewhat different products (Ex. Restaurant meals)	Minor	Most of the retailing sector, textiles, restaurants
Oligopoly	Few	Companies produce and sell identical or differentiated products (Ex. Tooth paste)	May be considerable	Much of the manufacturing sector, esp. autos, steel, and cigarettes
Pure Monopoly	One	Unique product	May be considerable	Public utilities

C. Commenters' General Assessment of the Level of Competition

In the May 28, 2004 Order that initiated this Investigation, the Commission requested comments on different factors that it should take into account in assessing whether "effective competition" exists in the natural gas supply service market. May 28, 2004 Order at p. 2. These factors included price, consumer education, customer information and service, supplier financial security requirements, and natural gas distribution company penalties and other costs. The Commission also requested that commenters assess the level of competition in Pennsylvania's natural gas supply service market and suggest ways to encourage increased competition.

The Commenters' assessment of competition in the market fell along expected lines. The EAP and the NGDCs that responded separately believed that competition exists in the market place.[22] The suppliers and customers believe that competition is lacking and could be encouraged if certain changes were made.[23]

Regarding the specific criteria that the Commission should use in assessing competition, the commenters again were split. Some commenters argued that the falling numbers of customers and suppliers participating in the market demonstrated the lack of competition.[24] EAP and others argued that the numbers of suppliers and customers were not an indication of effective competition.[25] This was the case with regard to the other four criteria upon which the Commission sought comment making it necessary to discuss each criterion separately below.

As to the definition of "effective competition" in Section 2204(g), no commenter volunteered a definition of the term.[26] Accordingly, the Commission, as the agency responsible for interpreting its own enabling legislation, will define "effective competition." *Popowsky, supra.*

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[22] EAP Reply Comments, p.1, EAP Testimony, Tr. 9; Columbia Comments, pp. 1-2; UGI Comments, p. 9; Dominion Peoples Comments, pp. 8-9.

[23] Utilitech Comments, p.1; Shell Energy Comments, p. 2; Dominion Retail Comments, pp. 1-2; NRG Testimony, Tr. 56.

[24] IOGA Comments, p. 2; Shipley Comments, p. 3.

[25] Dominion Peoples Comments, p. 9 (Dominion Peoples considers competition on its system to be a success even though suppliers have dropped from 37 in 1999 to 20 in 2005).

[26] The Commission's Order did not request that commenters provide a definition of "effective competition."

D. Definitions of "Effective Competition" and Similar Terms from Other Jurisdictions and Resources.

The Competition Act does not define "effective competition," and the term is not defined in any other Pennsylvania statute.[27] However, other jurisdictions have formulated definitions of "effective competition" and other similar terms. For example, Nevada law defined "effective competition" as follows:

> "effective competition" means, with respect to a particular service, a market structure and a process under which an individual seller is not able to influence significantly the price of the service as a result of:
> (1) The number of sellers of the service;
> (2) The size of each seller's share of the market;
> (3) The ability of the sellers to enter or exit the market; and
> (4) The price and availability of comparable substitutes for the service.

NAC § 704.7931 ("effective competition" defined).

On the other hand, New Mexico law lists several factors used to determine whether a particular telecommunications service was subject to effective competition:

> (1) the extent to which services are reasonably available from alternate providers in the relevant market area;
> (2) the ability of alternate providers to make functionally equivalent or substitute services readily available at competitive rates, terms and conditions; and
> (3) existing economic or regulatory barriers.

NMSA 1978, § 63-9A-8(B).

See also The Mountain States Telephone And Telegraph Company v. N.M. State Corporation Commission, et al., 109 N.M. 504; 787 P.2d 423 (N.M. 1990)

Missouri telecommunications law, likewise, sets forth factors that the Missouri Commission must consider in determining whether "effective competition" exists in regard to a particular telecommunications service:

> (a) The extent to which services are available from alternative providers in the relevant market;

[27] The term "effective competition" is used in, but not defined in the *Feature Motion Pictures Fair Business Practices Law* at 73 P.S. §203-2. Likewise, there is no case law interpreting this term.

(b) The extent to which the services of alternative providers are functionally equivalent or substitutable at comparable rates, terms and conditions;
(c) The extent to which the purposes and policies of chapter 392, RSMo., including the reasonableness of rates, as set out in section 392.185, RSMo., are being advanced;
(d) Existing economic or regulatory barriers to entry; and
(e) Any other factors deemed relevant by the commission and necessary to implement the purposes and policies of chapter 392, RSMo.

Section 386.020(13) RSMo.

See also State of Missouri ex rel., Acting Public Counsel John Coffman, Missouri Independent Telephone Group, et al., v. Public Service Commission of the State of Missouri, et al., 154 S.W.3d 316 (Mo. App. 2004).

In defining "effective and sustainable competition," the Public Service Commission of Wisconsin took a more quantitative approach to assess competition in its electric generation market. Relying on classic economic concepts, the Wisconsin Commission first created a "workable competition" standard.[28] The standard consisted of:

(1) A reasonable number of suppliers (HHI[29] of 2,000 to 2,500);

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[28] *Investigation on the Commission's Own Motion into the Need for Changes in Natural Gas Regulation for City Gas Company; Florence Municipal Gas Utility; Madison Gas and Electric Company: Midwest Natural Gas, Inc.; Natural Gas, Inc.; Northern States Power Company; St. Croix Valley Natural Gas Company; Superior Water, Light and Power (Phase III) Company; Wisconsin Fuel and Light Company; Wisconsin Gas Company; Wisconsin Natural Gas Company; Wisconsin Power and Light Company; and Wisconsin Public Service Corporation (Wisconsin Electric Power Company, Gas Operations, formerly Wisconsin Natural Gas Company).* Public Service Commission of Wisconsin, Docket 05-GI-108.

[29] The Herfindahl-Hirschman Index (HHI) is a well-known measure of industrial competition and it helps gauge how competitive an industry is. *See, e.g.*, M. W. Frankena and B. M. Owens, *Electric Utility Mergers: Principles of Antitrust Analysis*, (Westport, Connecticut: Praeger: 1994)("*Frankena and Owens*") The HHI is calculated as the sum of the squares of market share. For example, a monopoly has a market share of 100%, and so the HHI for a monopoly is $100^2 = 10,000$. For a very competitive industry, each firm has a very small market share and the HHI is close to zero. *Frankena and Owens.*

"As an intuitive guide, analysts assessing market concentration (i.e.. whether competition exists) view an HHI below 1,000 as a competitive market. HHI's between 1,000 and 1,800 suggest that the market is more concentrated and less competitive. HHI's over 1,800 indicate strong market concentration, and the need for further analysis to determine if adequate competition exists in the market. However, it is widely recognized that the HHI thresholds are not based on empirical evidence concerning the relationship between concentration/competition and the likelihood that market power will be exercised." *Frankena and Owens.*

(2) Low barriers to competition;
(3) Sufficient available capacity;
(4) Responsive suppliers; and
(5) Informed customers.

Using this standard, the Wisconsin Commission determined that an "effectively competitive" market would have a reasonable number of firms, low barriers to competition, sufficient available capacity, responsive suppliers and informed customers.

The Council for the District of Columbia has also established a definition for "effective competition" in regard to electric generation competition:

> "Effective competition" means, with respect to the markets for electricity supply, billing, and those services declared . . . to be potentially competitive services a market structure under which an individual seller is not able to influence significantly the price of the service as a result of the number of sellers of the service, the size of each seller's share of the market, the ability of the sellers to enter or exit the market, and the price and availability of comparable substitutes for the service.

Council of the District of Columbia, 47 D.C. REG. 1091, §101 (16).

Definitions for terms similar to "effective competition" have been adopted by other entities and include concepts that are worthy of consideration in defining "effective competition." Staff from the Energy Information Administration (EIA), U.S. Department of Energy,[30] listed signs of a "sufficiently competitive" market as including one or more of the following characteristics:

(1) Many buyers and sellers
(2) Many product options
(3) Relative ease of entry and exit
(4) Risk, on the part of the service provider, of losing money if they do not operate efficiently.

[30] The Energy Information Administration was created in 1977 by Congress and is the statistical agency of the U.S. Department of Energy. The EIA provides policy, independent data, forecasts and analyses to promote sound policy making, efficient markets and public understanding of energy and its interaction with the economy and the environment.

Mariner-Volpe, Barbara, and Trapmann, William, Energy Information Administration, *The U.S. Natural Gas Markets and Industry, (EIA PowerPoint Presentation)*, May 13, 2003, Slide 21 of 40.

The Independent Regulators Group ("IRG") from the European Union[31] in an Internet article[32] states that "effective competition" can be defined as the "persistent absence of players with market power."[33] IRG explains that while perfect competition is a static theoretical concept, "effective competition involves a more dynamic practical view."[34] Hence, for a market to be effectively competitive, it is necessary that this situation be sustainable. In other words, the possibility that one or more players can acquire market power is not consistent with effective competition. *Id.* As to its defining characteristics, IRG states that "effective competition" retains the main features of the competitive process in that:

(1) Agents (buyers or sellers) behave competitively.
(2) Consumers are offered a variety of products.
(3) Firms are efficient and are able to innovate.

IRG Article, ¶2.3.

IRG also states that the importance attached to effective competition is better appreciated in terms of its outcomes for consumers. According to IRG, consumers are better off in an effectively competitive market because they are more likely to find a better deal to meet their needs. *IRG Article*, ¶ 2.5. Therefore, in addition to the traditional structural criteria, consideration is given to particular aspects of customer care,

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[31] Established in 1997, Independent Regulators Groups for telecommunications includes members from 15 countries from the European Union, the European Economic Space (Iceland, Norway and Liechtenstein), Switzerland and from the candidate countries to the European Union (Bulgaria, Poland, Czech Republic, Hungary, Romania, Latvia, Lithuania, Slovak Republic, Slovenia and Estonia and Cyprus). The groups work as informal forums of discussion and information exchange about issues relating to the regulation and development of the European telecommunications market.

[32] Independent Regulators Group, *Principles of Implementation and Best Practice on Effective Competition in Electronic Communications Market* (February 19, 2001) ("*IRG Article*"), found May 12, 2005 at http://www.regtp.de/imperia/md/content/internatio/pibs_on_effective_competition.pdf.

[33] *IRG Article* ¶2.3.

[34] *Id.*

responsive pricing, availability of innovative services, the extent of choice available, availability of appropriate information on prices and quality, evidence of efficiency in the provision of service and value for money. *Id.*

E. "Effective Competition" Defined.

As discussed previously, Pennsylvania's General Assembly delegated the task of defining "effective competition" to the Commission. The Competition Act does not provide specific guidance to the Commission in this task. However, it would seem reasonable that the parameters adopted by others in defining "effective competition" and other similar terms would be same ones that the Commission should consider, and in fact, did solicit comment on in its investigation order:

(1) number of active suppliers;
(2) number of retail customers served by alternate suppliers;
(3) volume of natural gas transported on NGDCs' systems for customers served by NGSs.
(4) effect of price of natural gas on competition.
(5) presence of possible barriers to market entry, participation and exit by NGSs (NGDC security requirements, penalties for under delivery, mandatory assignment of capacity).
(6) presence of possible barriers that may limit customer participation (lack of accurate immediate pricing information, lack of consumer education).

Commission Order entered May 27, 2004 at Docket No. I-00040103, Annex A.

Accordingly, for the purpose of this Investigation, the Commission adopts the following factors as indicia of "effective competition" in the defined retail natural gas supply market:

(1) Participation in the market by many sellers so that an individual seller is not able to influence significantly the price of the commodity.
(2) Participation in the market by many buyers.
(3) Lack of substantial barriers to supplier entry and participation in the market.
(4) Lack of substantial barriers that may discourage customer participation in the market.
(5) Sellers are offering buyers a variety of products and services.

F. Methodology.

Pursuant to its authority at Section 335(a) of the Public Utility Code, 66 Pa. C.S. §335(a), the Commission is the ultimate finder of fact and makes all determinations as to the weight and credibility of evidence. *PP&L Industrial Consumer Alliance v. Pa. PUC*, 780 A.2d 773 (Pa. Cmwlth. 2001); *Borough of Duncannon v. Pa. PUC*, 713 A.2d 737 (Pa. Cmwlth. 1998). The court may determine only whether Commission findings are supported by substantial evidence; the court may not substitute its judgment for that of the Commission, nor "indulge in the processes of weighing evidence and resolving conflicting testimony." *Popowsky, et al. v. Pa. PUC*, 706 A. 2d. 1196 (Pa. 1997). *See also Johnstown-Pittsburgh Express, Inc. v. Pa. PUC*, 291 A.2d 545, 547 (Pa. Cmwlth. 1972).

In Section 2204(g) the General Assembly charged the Commission with the duty of evaluating competition in the retail natural gas market as it developed under the Competition Act. This Investigation was undertaken to fulfill that duty.

The record in this Investigation consists of comments, reply comments, responses to data requests submitted by the NGSs and NGDCs and testimony and exhibits presented at the September 30, 2004 *en banc* hearing before the Commission. The Commission carefully studied the record of this Investigation and assigned what it concludes is the proper weight to the evidence.

The statistical data provided in response to specific Commission data requests simplified our evaluation. On the other hand, the comments and testimony regarding the existence and magnitude of barriers to market entry and participation created by security requirements, capacity assignments and penalties for non-delivery were more difficult to assess.

However, after examining the statistical data submitted by NGDCs and others, it is not difficult to conclude that only a small number of suppliers are actually participating in Pennsylvania's retail natural gas market. Because a competitive market needs to attract and retain competitors, it is necessary to consider carefully the suppliers' concerns about the operation of the current market, including the existence and magnitude of barriers that the suppliers have identified that may have led them to make business decisions to forego participation in the market.

V. ANALYSIS

A. Number of Market Participants

1. Natural Gas Distribution Companies

The natural gas distribution companies provide natural gas distribution services and may provide natural gas supply services and other services as defined in 66 Pa. C.S. §2202. They are companies with annual operating revenues over $6,000,000 and include: Columbia, Dominion Peoples, Equitable, National Fuel, PECO Gas, PG Energy, PGW, PPL Gas, T.W. Phillips, UGI, Southern Union Company, Valley Energy, Inc. and GASCO Distribution Systems.

2. Natural Gas Suppliers

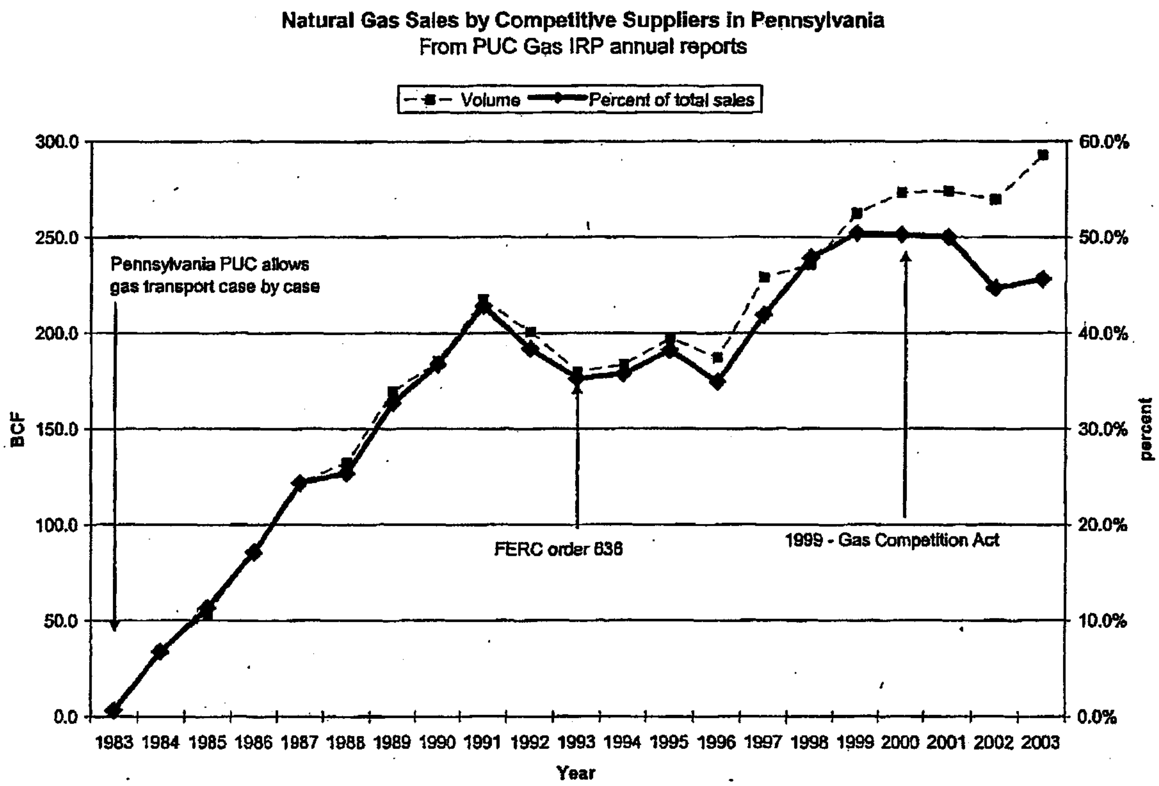
A natural gas supplier is an entity, other than an NGDC, but including an NGDC marketing affiliate, that provides natural gas supply services to retail customers using the jurisdictional facilities of an NGDC.[35] The term includes an NGDC that serves outside its certified territory and a municipal corporation that serves outside its corporate or municipal limits. The term expressly excludes an entity that provides free gas under the terms of an oil or gas lease. Note that an NGS is not a public utility.[36]

[35] 66 Pa. C.S. §2202 (relating to definitions).

[36] Commonwealth Court has held that natural gas suppliers are not "public utilities" and as such, are not subject to assessment for the funding of Commission regulatory activities pursuant to 66 Pa. C.S.§510. *Independent Oil and Gas Association of Pa., et al. v. Pa. PUC, Office of Consumer Advocate and Office of Small Business Advocate,* 804 A.2d 693 (Pa. Cmwlth. 2002).

a. Volume of Gas Transported

The Commission collects data on competitive activities through its Annual Resource Planning Report filings.[37] As shown in the following graph, since 1983, the volume of natural gas flowing under transportation rates has increased dramatically. However, since the inception of the Competition Act in 1999, there has been little to no change in the throughput[38] of competition volumes. In 1999, approximately 50% of the gas flowing in Pennsylvania was under a competitive tariff. In 2004, the volume is approximately 47.5%.

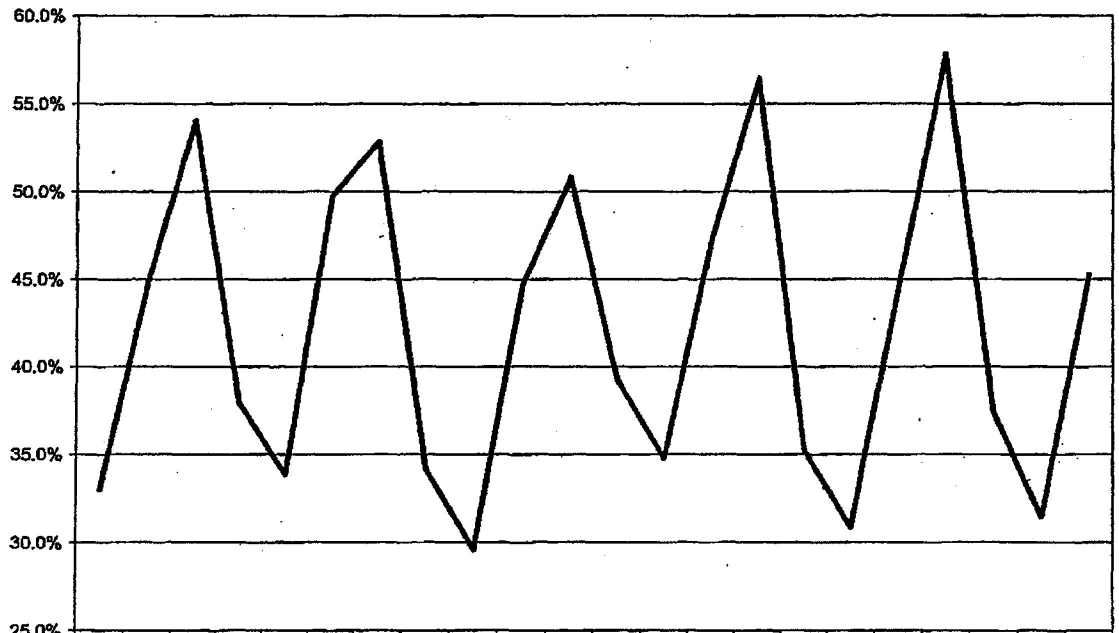


[37] *See* 52 Pa. Code §§59.81-59.84 (relating to Annual Resource Planning Report).

[38] The term "throughput" is commonly used to describe the volume of natural gas moved over an NGDC's system during the course of some time frame, *e.g.*, the total volume of gas moved over an NGDC's system during one year. Usually, throughput is measured on an MCF, or thousand cubic feet, basis. However, some systems calculate throughput on a therm, or BTU , or heat content basis.

The quarterly data, like the annual data, shows that the volumes transported for NGSs have remained nearly constant over time. This is demonstrated in the following graph.

Percent of Total NG Transported by NGSs by Quarter



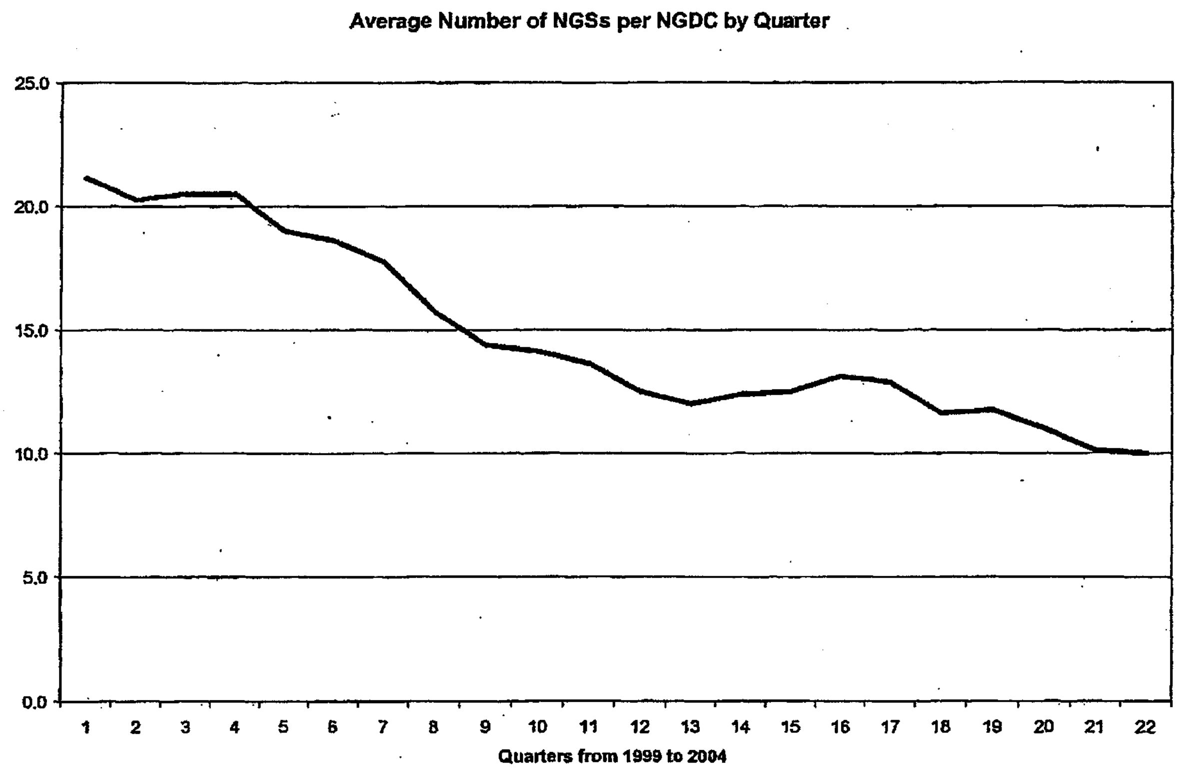
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22
Percentage	33.0	44.9	54.0	38.0	33.9	49.7	52.8	34.2	29.6	44.7	50.8	39.3	34.8	47.2	56.4	35.3	30.9	44.5	57.8	37.4	31.5	45.3

Percentage of Gas Transported by Quarter from 1999 to 2004

b. Number of Suppliers

In Annex A to its Investigative Order, the Commission asked the NGDCs and NGSs to supply data for the Commission to review. These data responses formed the basis for the following analysis. Generally, nine of the ten major NGDCs filed data in a form that could be analyzed. Of the nine service territories, five had fewer NGSs operating on their systems in 2004 than in 1999. Two had more NGSs, and one had the same number of NGSs. One did not respond. Of the nine, three had increased competitive volumes flowing in 2004, over 1999. Five had the same, or equivalent volumes from 1999 to 2004. One did not respond.

The following chart demonstrates the average number of suppliers per NGDC per quarter from, 1999 to 2004. A point on the graph represents the average of the sum total of each responding NGDC's estimate of the total number of active NGSs serving customers in its service territories in a quarter.[39] By the way of explanation, if there were 6 NGSs serving customers in one territory and 2 NGSs serving customers in another territory, there would be a total of 8 NGSs. To get the average, take 8 NGSs divided by 2 territories to get an average of 4 NGSs per NGDC. As shown, early in 1999 the average number of NGSs per NGDC was just over 20. That number has dropped to 10 NGSs per NGDC in the fourth quarter of 2004.



[39] During the second quarter of 2004, Peoples had 20 NGSs active and serving load, while TW Phillips had 1 NGS.

Not only the average number of NGSs per NGDC is decreasing, but also the total number of NGSs has decreased slightly. According to Commission records regarding licensing, as of May 2005, there are 81 NGSs licensed to provide natural gas supply services.

NATURAL GAS SUPPLIER LICENSES

YEAR	# JAN 1	GRANTED	CANCELLED	# DEC 31
2002	84	7	13	78
2003	78	4	4	78
2004	78	8	4	82
2005	82	2*	3*	81*

*As of May 12, 2005.

3. Buyers/Shopping Customers

a. Consumer Education

The Commission was a partner in the Utility Choice program, a consumer education program, overseen by the Council for Utility Choice (CUC). In addition to the Commission, the CUC also is made up of consumers, small-business and utility representatives, and representatives from the Governor's Advisory Commission on African American Affairs, the Governor's Advisory Commission on Latino Affairs, and the Pennsylvania Rural Development Council. The Utility Choice program, which ended at the end of 2004, educated Pennsylvania consumers about natural gas, electric and local telephone competition, and the opportunity to buy services from alternative suppliers.

The two-year natural gas consumer-education program was funded by $2.4 million in assessments from the following NGDCs: Columbia; Dominion; Equitable; NFG; PG

Energy; UGI-Gas; PECO; Penn Fuel Gas/North Penn; T.W. Phillips; and Valley Cities. The amount of the assessment was based on the number of customers for each company.

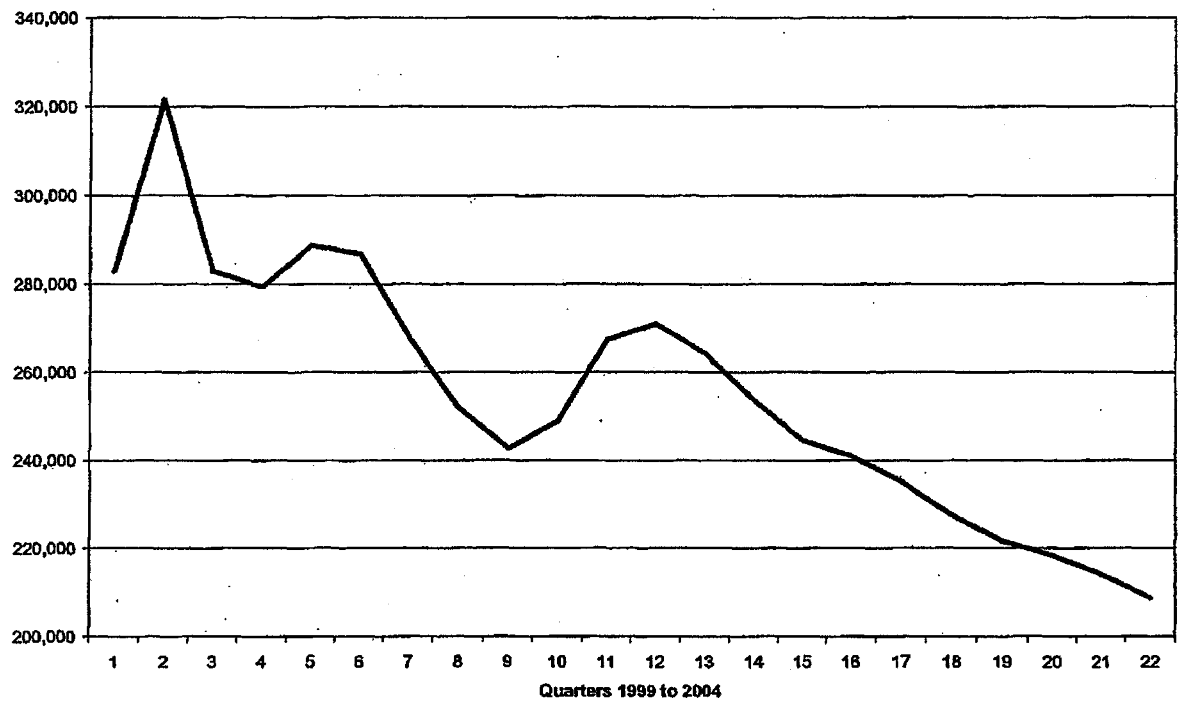
Three surveys were completed that measured the effectiveness of the Natural Gas Choice consumer education program. The most recent survey was conducted in August 2004 (1,205 respondents statewide were surveyed with a margin of error of plus or minus 2.8 percent). According to the August 2004 survey results, 55 percent of gas customers were aware that they are allowed to choose their own supplier of natural gas, and 16 percent have shopped for a different supplier of gas. Fifty-eight percent of gas customers said they did not have enough information to make a decision about participating in the Natural Gas Choice program. Nineteen percent of gas customers wanted more information about rates and savings, and 10 percent wanted more information about competing suppliers.

A survey in March 2001 revealed 71 percent awareness, and a survey in February 2003 yielded a 62 percent awareness level (although Philadelphia residents were not included). Not accounting for the fact that Philadelphia residents were included in only one of the three surveys, 63 percent of the surveyed consumers were aware of Natural Gas Choice and their ability to participate in the program.

b. Number of Customers

The total number of customers obtaining natural gas supply from NGSs was at an all time high in the second quarter of 1999. That high mark was 321,539, or about 11% of the total number of just under 2.8 million customers. By the fourth quarter of 2004, that number had fallen to 208,849, or about 7% of the total number of just under 2.8 million customers. This decrease in customer numbers is depicted in the following graph.

Number of Customers Shopping by Quarter



Of the nine NGDCs, three had fewer customers participating. Three had more customers participating. One had the same number of customers participating. Two NGDCs did not respond.

Looking just at the residential marketplace, one NGDC had the same number of residential customers participating between 1999 and 2004. Three NGDCs had decreasing numbers of residential customers shopping. Two NGDCs had no residential customers shopping. Three NGDCs did not respond.

The OCA also keeps records of the number of residential customers that are shopping for natural gas. As shown in the following table, the total number of residential customers shopping in October 1999 was 253,734. By April 2005, this number had dropped to 177,534. The most recently available figure on the number of residential customers obtaining supply from NGSs was 174,141 as of July 1, 2005. August 2005.[40]

[40] OCA's shopping statistics for residential natural gas customers for the month of August 2005 may be

Number of Residential Customers Shopping by Date (Source: PA OCA's Natural Gas Shopping Statistics)								
	Oct-01	Apr-02	Oct-02	Apr-03	Oct-03	Apr-04	Oct-04	Apr-05
Columbia	111,914	109,000	92,760	86,974	80,715	77,754	78,058	74,492
Dominion Peoples	114,747	112,989	102,607	95,725	90,393	87,609	84,285	79,481
Equitable	27,071	24,366	22,997	21,591	20,646	20,359	19,510	18,836
NFG	0	0	0	0	0	0	0	0
PECO	2	8	794	1,235	1,594	1,704	1,720	1,777
PG Energy	0	0	0	0	0	0	0	0
PGW	0	0	0	0	0	0	0	0
PPL Gas	0	0	0	0	0	0	0	0
TW Phillips	0	0	0	0	0	0	0	0
UGI		1,251	1,876	4,186	3,683	3,081	2,951	2,948
Valley Cities, NUI	0	0	0	0	0	0	0	0
TOTAL	**253,734**	**247,614**	**221,034**	**209,711**	**197,031**	**190,507**	**186,524**	**177,534**

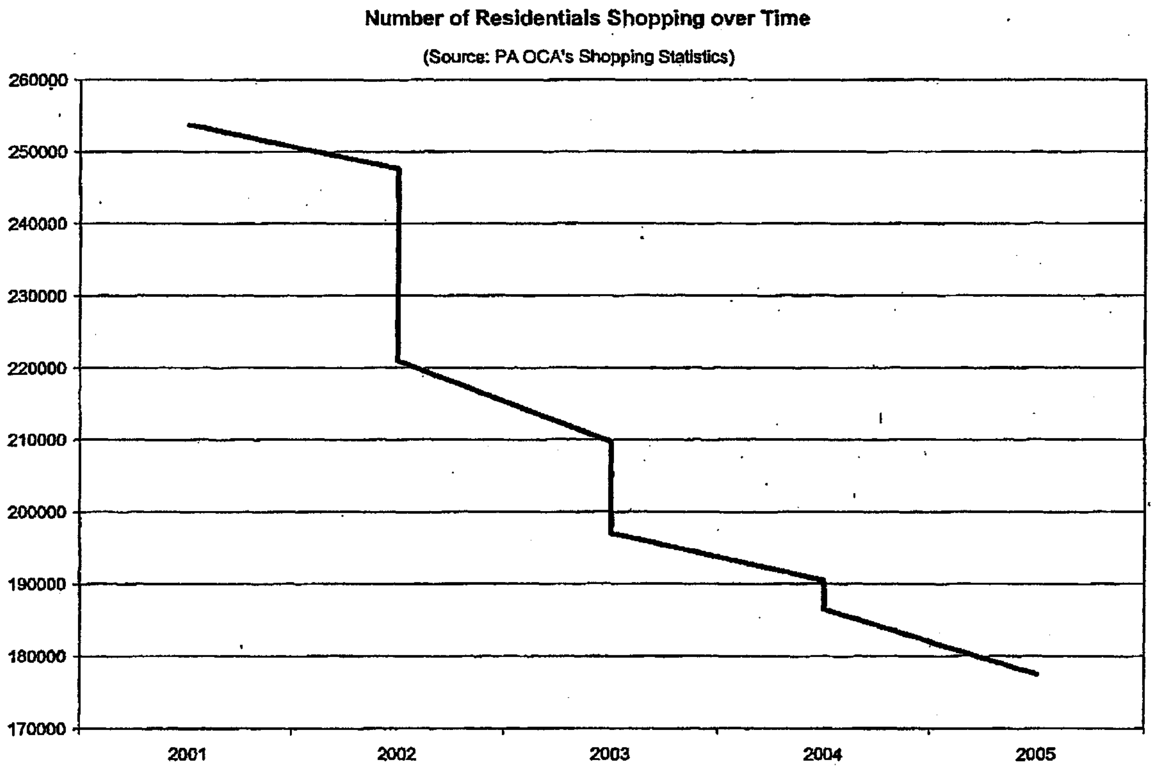
According to the OCA[41], nearly all the residential customer switching has occurred among the customers of three western Pennsylvania-based companies – Columbia, Dominion Peoples, and Equitable. This fact is demonstrated from the above chart. The reason for this, the OCA believed, is that those three companies already had substantial retail choice "pilot" programs ongoing well before the 1999 legislation was passed. During those pilot programs, customers who switched from their utility to an alternative gas supplier were exempted from paying the 5% gross receipts tax on their monthly gas bills.

accessed at http://www.oca.state.pa.us/cinfo/gstats0705.pdf.

[41] OCA Comments, pp. 3-4; OCA Testimony, Tr. 61-62.

The OCA also states that when the Competition Act was passed, however, this advantage was lost because the gross receipts tax was eliminated on all natural gas service.[42] There has been virtually no retail competitive activity for residential customers in most of the remaining natural gas service territories. Even among the three western Pennsylvania gas utilities, the number of customers served by alternative suppliers has decreased by about 20% since the beginning of 2001.

This data is shown in the following graph.



The data responses show that, with respect to residential volumes, one NGDC had a decrease in residential volume. One had the same volumes. Two NGDCs had zero

[42] *Id.*

residential volumes flowing through competition. Five other NGDCs did not respond to the data request.

Customer participation in the market is of course dependent on the willingness of suppliers to extend service offers to customers. NGSs may find residential customers unattractive to serve because of acquisition costs, load factors, credit risk, and other reasons[43] unrelated to requirements for market participation.

4. Possible Effect of External Forces on Pennsylvania's Retail Market

Regardless of how "effective competition" is defined, or the economic model being used, it is a difficult task to analyze the change in the levels of competition over time. There are macro-economic changes in the wholesale market that trickle down and affect the retail market. An example of these changes would be the increased wholesale price and volatility in the wholesale natural gas markets caused by an increase in total US-wide demand, without an attendant increase in supply.[44] In fact, this supply/demand imbalance has become great enough in today's wholesale market to induce interest in the construction of liquefied natural gas facilities that would provide for the importation of natural gas from around the world.[45]

Moreover, weather can affect the wholesale, and consequently, the retail market price. Weather changes over time. Change occurs from day-to-day, week-to-week, and

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[43] OCA Comments, pp. 5-6.

[44] During the 1999-2000 price spike, the Commission observed a number of failures and exits by long-time gas marketers. Such occurrences are generally symptomatic of a rising wholesale market. where extensions of credit are not as freely available in sufficient amount to cover price escalations.

[45] A good overview of Liquified Natural Gas and related issues is given in *Chemical & Engineering News*, April 25, 2005, Volume 83, Number 17, pp. 19-22. This article may be found at www.pubs.acs.org/cen/coverstory/83/8317LNG.html *See also* various FERC filings for *Dominion Cove Point LNG, LP*, FERC Docket No. RP05-213-000.

year-to-year. Cold winters cause much larger price movements, than warmer winters. Similarly, the increasing reliance on natural gas for electric generation has affected the wholesale marketplace.[46]

Other events may have affected the development of competition at the retail level, including, most significantly, the impact of Enron's bankruptcy on the wholesale and retail marketplaces.[47] For example, Enron's bankruptcy may have affected the financial community's view of marketing and trading companies in general which in turn resulted in a contraction of credit for these entities and a loss of market liquidity. Consequently, the number of traders and the volume of financial and physical natural gas transactions may have been reduced. Also, commodity price and market volatility may have increased due to the increasing participation of non-gas related entities in the NYMEX[48] natural gas market.

By itself, or in combination with other macro-issues, these wholesale market concerns could have affected the level of competition in Pennsylvania's retail natural gas supply market from 1999 to 2004. Without further study, it is difficult to draw any definitive conclusions regarding which, if any, of these factors had a material impact on the development, or disintegration, of this competitive retail market.

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[46] *Testimony Regarding Diversification of Power Generation Resources* by Sonny Popowsky, Consumer Advocate of Pennsylvania, before the U.S. Senate Energy and Natural Resources Committee, March 8, 2005, found at:
http://www.nasuca.org/Sonny%20Popowsky%20%20Senate%20Energy%20Testimony%203-8-05.pdf.

[47] *See, e.g.*, University of Pennsylvania, Research, Business Section: *After Enron, Who Else Goes Down, and When?*, dated December 5, 2001, found September 8, 2005 at
http://www.upenn.edu/researchatpenn/article.php?170&bus.

[48] NYMEX – New York Merchantile Exchange NYMEX is the world's largest physical commodity futures exchange and the preeminent trading forum for energy and precious metals. Transactions executed on the NYMEX avoid the risk of counterparty default because NYMEX clearinghouse acts as the counterparty to every trade. The NYMEX pioneered the development of energy futures and options contracts 26 years ago as a means of bringing price transparency and risk management to this vital market..

However, it is important to note that the preceding discussion is meant to provide a perspective on the other forces[49] that may have affected, and may continue to affect Pennsylvania's retail natural gas market. These forces are not within the authority, or the direct control of the Commission or the market participants, and as such, for purposes of this investigation, have not been incorporated into our analysis regarding the level of competition in the statewide retail natural gas market.

B. Barriers to Supplier Entry and Participation

In their comments, reply comments and testimony, the majority of commenters (other than NGDCs) accepted as a given that there is not "effective competition" in Pennsylvania's natural gas industry and identified barriers to supplier participation in the market. In so doing, the commenters also offered suggestions that could be implemented to increase competition. Only EAP and the NGDCs indicated that "effective competition" as envisioned in Chapter 22 existed in the retail natural gas market, and that no changes needed to be made to the legislation.

1. Security Requirements.

A number of commenters identified high security requirements for licensing as a barrier to market entry for suppliers. Section 2208(c)(relating to financial fitness) of the Public Utility Code[50] requires that in order to obtain or maintain an NGS license, a supplier must furnish a bond or other security in a form or amount as determined by the NGDC. Section 62.111 of the Commission's regulations carries out this statutory requirement, and dictates that:

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[49] Commenters have also discussed the possible negative effect of these and other outside influences on competition in the gas supply market. *See* IOGA Comments, p. 3; OCA Comments, p. 5-6; UGI Comments, p. 3.

[50] 66 Pa. C.S. §2208(c).

> The amount of the security should be reasonably related to the financial exposure imposed on the NGDC or supplier of last resort resulting from the default or bankruptcy of the licensee. At a minimum, the amount of security should materially reflect the difference between the cost of gas incurred and the supplier's charges, if any, incurred by the NGDC or supplier of last resort during one billing cycle;

52 Pa. Code §62.111(c)(1).

The regulation also allows a variety of security instruments to be used to satisfy the requirement including bonds, irrevocable letters of credit and for companies with annual operating revenues less than $1 million, real or personal property that meet certain criteria. 52 Pa. Code §62.111(c)(2)(3).

In reviewing the record in this Investigation, the Commission found that security issues were of high importance to both NGDCs and NGSs. Accordingly, we will discuss many of the NGS and NGDC comments herein.

Numerous commenters claimed that the high security amounts and the limited forms of security accepted by NGDCs (bonds and irrevocable letters of credit) acted as a barrier to market entry by suppliers.[51] Interstate Gas Supply comments that security requirements not based on definitive credit worthiness can have an anti-competitive effect, and states that if a marketer can provide financial statements that demonstrate an acceptable financial picture or an S&P, Moody, or Dun & Bradstreet rating at an acceptable level, the security requirement should be reduced.[52]

NEMA contends that financial security requirements should be designed to provide the NGDC with reasonable compensation in the event of supplier default.[53]

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[51] Shipley Comments, pp. 5-7; Utilitech Comments, pp. 1-2.

[52] Interstate Gas Supply Comments, p. 5.

[53] NEMA Comments, p.7.

Requirements should reflect reasonable costs of securing supplies during reasonable weather conditions.[54] Companies with certain S&P or Moody ratings should already meet reasonable standards.[55] Direct Energy states that suppliers with high credit ratings should be permitted to provide reduced security.[56]

In their Joint Reply Comments, Suppliers note that in keeping with the current statutory scheme, either the NGS or the NGDC should be able to propose an adjustment to the actual exposure based on the level of risk of the supplier actually defaulting.[57] In other words, the Commission's regulations should have a two-tiered structure: the first tier should be based on actual exposure.[58] In the second tier, actual exposure can be adjusted based upon the individualized risk or lack of risk factors depending on the case.[59] If the NGS can show it is a low risk, it can have a lower requirement; if the NGDC can show the NGS is a higher risk, the NGS would need more security. Under this system, the Commission would be the final arbiter of any dispute and should monitor security requirements to ensure fairness and uniformity.[60] Such a system assumes that any NGS meeting the same requirements will be required to post the same amount of security per customer.[61] Interstate Gas Supply agrees that credit criteria [security] should

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[54] *Id.*

[55] *Id.*.

[56] Direct Energy Comments, pp. 6-7.

[57] Suppliers' Joint Reply Comments – Shipley, Shell Energy, Dominion Retail, Direct Energy Services, Interstate Gas Supply (Suppliers' Joint Reply Comments), p. 9.

[58] Suppliers' Joint Reply Comments, p. 9.

[59] *Id.*

[60] Suppliers' Joint Reply Comments, p. 9.

[61] *Id.*

be standardized across the board and be based upon the financial strength of the individual supplier.[62]

Shipley comments that security requirements should be "bi-lateral" and based on the level of NGS revenue that the NGDC is holding.[63] Allowing marketers to pledge their accounts receivable balances to the NGDC would help in reducing the security requirement under the NGDC's tariffs.[64]

Interstate Gas Supply states that other types of collateral should be permitted as security.[65] In their Joint Reply Comments, the Suppliers advocate that an NGDC should not be permitted to require only a single form of security or a non-industry standard form.[66] At a minimum, NGDCs should be required to accept industry standard bonds, letters of credit, cash collateral or corporate guarantees (from entities with investment grade debt ratings).[67]

The NGSs also voiced their opinions that there should be greater options in providing security. Marketers should be allowed to issue bonds, letters of credit on a variety of other sources.[68] Others should be able to meet the financial standard with, for

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[62] Interstate Gas Supply Testimony, Tr. 39.

[63] Shipley Comments, p. 7.

[64] Mack Service Group Comments, p. 3.

[65] Interstate Gas Supply Comments, p. 5.

[66] Suppliers' Joint Reply Comments, p. 9.

[67] *Id.*

[68] Shipley Testimony, Tr. 50.

example, cash, letters of credit, parental guarantees or a reasonable bonding requirement.[69]

Security requirements should be transparent. They should be non-discriminatory and based on realistic calculations of true exposure that utilities face.[70]

Because the amount and form of security is determined by the NGDC against whom the NGS competes, security requirements not based on definitive credit worthiness can have anti-competitive effects.[71] Also, security requirements that varied among NGDCs discouraged suppliers from broader participation in the market.[72]

EAP continues its support of individual NGDC security requirements.[73] Dominion Peoples claims that its financial security requirements have not drawn any complaints and are not negatively affecting competition[74]. Security requirements are designed to protect customers and to ensure that the NGS is financially sound to secure supply for the load it has committed to serve.[75] They also safeguard the NGDC (and ultimately the NGDC's customers) from having to bear the cost of an insolvent NGS's abandoning its obligations.[76]

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[69] NEMA Comments, p. 7; Direct Energy Comments, p. 7. A "parental guarantee" is a promise by a parent company to pay some debt, or to perform some legal duty in case of failure of another who is liable for the debt or performance of the duty. *Blacks Law Dictionary,* (West 8th ed. 1999) p. 724 (def. of 'guaranty').

[70] Shipley Testimony, Tr. 50.

[71] Interstate Gas Comments, p. 5.

[72] Suppliers' Joint Reply Comments, pp. 2-3.

[73] EAP Comments, pp. 12-13.

[74] Dominion Peoples Comments, p. 13.

[75] *Id.*

[76] Dominion Peoples Comments, p. 13.

Summation

An NGDC has the authority to establish the amount and the form of security an NGS must provide not only to operate on the NGDC's system, but also to maintain its license as a natural gas supplier in this Commonwealth. *See* 66 Pa. C.S. § 2208(c). To the extent that NGDCs require security in a form, or in an amount so excessive that it makes it burdensome for a supplier to maintain its license or participate in the NGDC's marketplace, existing security requirements may be anti-competitive and according to suppliers acts as a market barrier to entry.[77] Also, the varying and multiple security requirements among NGDCs increase the cost of doing business for a supplier who wishes to operate in more than one NGDC service territories and thus, represents a significant barrier to supplier entry into, and participation in the retail natural gas market on a statewide basis.

2. Capacity Assignment.

Section 2204 (d)(1) of the Competition Act allows the NGDC the option to release, assign or otherwise transfer capacity or Pennsylvania supply in whole or in part on a nondiscriminatory basis to licensed NGSs or industrial customers on its system. 66 Pa. C.S. §2204 (d)(1). Section 2204(d)(4) requires a licensed NGS to accept such release, assignment or transfer of capacity. 66 Pa. C.S. §2204(d)(4).

According to OCA, the capacity assignment provisions of the Competition Act addressed two important concerns:

[77] In *Petition of Shipley Energy Co. for a Modification of Security Requirement,* Order entered July 9, 2004 at Docket No. P-0032045, p. 16, the Commission determined that Shipley had not met its burden of proving that UGI's security amount constituted a barrier to competition. It is noted, however, that the Commission did reduce the amount of security that UGI could request from the supplier, calculating the security amount using a 30-day billing cycle and the average gas cost for the two coldest months of two consecutive years. Order at pp. 13-14. The Commission's order was affirmed on appeal by Commonwealth Court. *See UGI Utilities, Inc. v. Pa. PUC,* 878 A.2d 186 (Pa. Cmwlth. 2005). UGI filed a petition for review with the state Supreme Court on August 8, 2005 at Docket No.655 MAL 2005.

(1) to ensure suppliers had adequate and reliable resources to deliver gas to the NGDC to serve customers and
(2) to ensure that NGDCs did not incur and remaining sales customers did not have to pay for "stranded" interstate pipeline costs associated with customers who migrated to service by an alternate supplier. The capacity assignment ensured both reliability and fairness to customer choice participants and consumers who remained with the utility.

OCA Comments, p. 10.

Many commenters have identified the assignment to suppliers of pipeline capacity as a barrier to market entry. EAP indicates that the capacity assignment provisions are necessary to maintain reliability.[78] UGI states that it has not assigned gas supply assets to NGSs to date. However, UGI states that the rules allowing NGDCs to assign pipeline transportation and storage capacity to NGS are necessary to avoid creating stranded costs and to provide for reliable service.[79]

Texas Eastern, the only pipeline company to participate in this Investigation, states that the most significant development at FERC is Order 637 issued on Feb. 9, 2000. Order 637 provided for increased pipeline services in the secondary market, market segmentation and capacity release, all of which have increased the value of primary transportation.[80]

Texas Eastern comments that continued reliable natural gas service is dependent on continuing contractual dedication of capacity, especially capacity at specific points that are operationally important (points of input, quantities of gas, and pressure) to

[78] EAP Comments, p. 6.

[79] UGI Comments, p. 9.

[80] Texas Eastern Comments, p. 4.

NGDC systems. Without access to the requisite firm upstream interstate pipeline capacity, there can be no assurance of continued reliable service.[81]

Also Texas Eastern comments that capacity should be adequate to cover peak days and average day deliveries, to preserve historical reliability and supply diversity, and to meet on a firm basis, new market demands.[82] Providers of service to firm load should be required to hold firm capacity with firm receipt points and firm delivery points sufficient to meet their peak day requirements.[83]

Texas Eastern comments that the supplier of last resort ("SOLR") should be given a clear signal that the costs of acquiring pipeline capacity and other assets on a firm basis sufficient to meet its obligations will be fully recoverable. Texas Eastern supports building additional pipeline capacity.[84] The SOLR must have contractually held non-recallable firm capacity at primary delivery points and primary receipt points as well as sufficient supply to meet customer needs.[85] SOLR must be able to meet obligations, and demonstrate a pre-existing capability to cover potential failures of the market.[86] There must be sufficient economic incentives for SOLRs to perform the standby supplier function for the entire period required to serve the market.[87]

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81 Texas Eastern Comments, pp. 7-8.

82 *Id.*.

83 *Id.*

84 Texas Eastern Comments, p. 5.

85 Texas Eastern Comments, p. 11.

86 *Id.*

87 *Id.*

OSBA states that as long as an NGDC will function as SOLR for priority customers, it will need to have sufficient capacity to serve both sales and transportation customers.[88]

Suppliers, however, oppose mandatory capacity assignment. They assert mandatory assignment of pipeline capacity by certain NGDCs is often excessive and/or unusable or too costly to serve retail customers. NGSs believe they should have the sole option of deciding whether or not to take assignment of upstream capacity.[89]

An NGDC has no incentive to reduce or reform contracts and the marketers are forced to pass the costs of the capacity to customers. According to New Energy, "mandatory assignment may be the primary reason that natural gas choice has not occurred in small commercial and residential markets."[90]

OSBA points out, however, that Section 2204(e), 66 Pa. C.S. §2204(e), allows NGSs to provide their own capacity, but the NGDCs have entered into new contracts to serve all priority customers and NGSs have agreed to continue to take capacity assignments.[91]

In regard to mandatory capacity assignment, OCA states that most Pennsylvania choice programs require a mandatory pro rata assignment of interstate pipeline capacity by NGDCs to NGSs as customers migrate to choice. OCA states that mandatory pro rata assignment of capacity may prevent third party suppliers from minimizing transportation costs and thus being able to compete effectively with NGDCs. When capacity is

[88] OSBA Comments, pp. 6-7.

[89] Dominion Retail Comments, p. 10.

[90] New Energy Comments, p. 8.

[91] OSBA Comments, p. 7.

assigned to an NGS on a pro rata basis, the cost of capacity assigned to the NGS is the same as the cost to the NGDC and thus, the NGS's costs for assigned capacity is fixed. Without this assignment, the NGS might be able to acquire cheaper capacity on its own.[92] OCA states that the mandatory capacity assignments under Section 2204(d) that require suppliers serving priority customers to take mandatory capacity assignment for three years should be kept in place. OCA also states that there should be a pro-rata share of capacity costs.[93]

OCA continues that the natural gas supply service provided by NGDCs against which third parties must compete consists of two cost components: gas supply commodity charges and demand (or capacity charges). Demand charges reflect the costs associated with reserving interstate pipeline capacity and storage capacity used to move that gas to the NGDC city gate. One way for the NGS to compete is to utilize its interstate pipeline capacity in a more efficient manner than the NGDC and achieve a lower per unit cost for delivered gas supplies.[94]

OCA also states that NGSs may also compete by offering natural gas service under different terms and conditions than the NGDC--such as a fixed rate for a longer period of time. An NGS might also compete by combining different services, like natural gas and electricity. However, current fixed price services are priced substantially above the current Price To Compare ("PTC")[95] so they are unattractive to consumers. Also,

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[92] OCA Comments, pp. 15-16.

[93] *Id.*

[94] *Id.*

[95] Commenters have used different terms for the NGDCs' commodity price of natural gas. To eliminate confusion, the term "Price to Compare" or "PTC" is used in this report.

there is no evidence that bundled services are being offered in Pennsylvania on terms attractive enough to induce customers to switch.[96]

NGDCs take issue with the failure of NGSs to use Commission proceedings to address the capacity assignment issue as provided for in the Competition Act. T.W. Phillips points out that no NGS has taken advantage of the opportunity to petition the Commission pursuant to Section 2204(d)(5)(ii) to prevent capacity assignments and authorize use by supplier of alternate capacity when it has been shown to be comparable, particularly in terms of reliability. Also, no NGS has intervened in any Section 2204(e) proceeding, wherein an NGDC must obtain Commission approval in advance of its acquiring any new or renewed firm transportation or storage service capacity that is used to maintain service to their customers. T.W. Phillips states that it has made several of these filings since 2000 and no supplier has intervened.[97] EAP claims that the NGSs' criticisms and refusal to take advantage of existing statutory avenues for providing alternate capacity, rest on their desire to replace firm interstate services with inferior substitutes.[98]

Summation

The position of the NGDCs is that firm capacity is essential to ensure reliability of service for customers. However, NGS have identified mandatory capacity assignment as a substantial barrier to supplier participation in the retail natural gas supply services market here in Pennsylvania. While it may be argued that the suppliers have cast some doubt on their willingness to risk their own capital to ensure delivery capability to their own markets by not intervening in Commission proceedings to challenge the renewal of

[96] OCA Comments, p. 17.

[97] T.W. Phillips Comments, p. 6.

[98] EAP Comments, p. 6.

capacity contracts, mandatory capacity assignment remains, from the suppliers' perspective, a barrier to market participation that should be addressed. Notwithstanding the identification of capacity assignment as a market barrier, the issue must be carefully considered, especially in regard to SOLR service where it is of vital importance that service be continuous and reliable.

3. Nomination and Delivery Requirements

Some NGDCs have nomination and delivery requirements[99] that align with the interstate pipelines; others do not. The varying rules regarding nomination and delivery create a barrier for a supplier that wants to serve over a number of territories.[100] Wholesale suppliers are reluctant to deliver in certain NGDC territories.

Shipley comments that tariffs in the western part of the state are more conducive to competition. A uniform set of rules that track the nomination requirements of interstate pipelines should be established. Also penalties for imbalance should be cost-based.[101]

Although Interstate Gas Supply strongly supports base load nominations, an error in daily nomination during a non-critical period should not result in excessive penalties.[102] Since the utilities retain the right to charge actual expenses incurred by the utility for over or under delivery by a marketer, the penalty is unnecessary.[103]

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[99] Nomination is defined as "the estimated volume that a customer informs the utility or marketer they will use or deliver for a specific gas day." Deliveries requirements are the "transportation volumes that are confirmed by the pipeline company for delivery to the customer at the delivery point and consumed by the customer." *See* MidAmerican Energy, *Industry Terms and Definitions for Customer Choice*, found May 12, 2005 at https://www.midamericanchoice.com/html/industryterms2.asp.

[100] Shipley Comments, pp. 8-9.

[101] *Id.*.

[102] Interstate Gas Comments, pp. 6-7.

In their Joint Reply Comments, the Suppliers state that the Commission should also look at nomination and delivery rules across the NGDCs with the goal of creating uniformity and fairness. Because market based penalties can insure delivery, fair and flexible nomination rules will not necessarily allow suppliers to harm NGDCs.[104]

Although not strictly related to delivery requirements, Dominion Retail indicates that the purchase of imbalance gas, monthly/daily cash outs and storage gas in place should simply be priced at the then-current market, rather than under complicated and unpredictable pricing schemes presently used by NGDCs.[105] Pooling requirements are cumbersome and act as a barrier to competition.[106]

Summation

Suppliers have identified the varying nomination and delivery requirements established by NGDCs as a barrier to entry, and participation in multiple NGDC markets. The Commission recognizes that nomination rules and delivery requirements are essential to ensure system reliability and that the NGDC system operational requirements may vary because of physical difference among the systems. However, inflexible or unreasonable nomination and delivery requirements may be anti-competitive, and as such, represent a barrier to supplier entry and broader supplier participation in the retail natural gas market. In considering this issue, the purpose of these requirements must be weighed against their impedance of broader supplier participation in the statewide market.

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[103] *Id.*

[104] Suppliers' Joint Reply Comments, p. 7.

[105] Dominion Retail Comments, pp. 3-4.

[106] Amerada Hess Comments, p. 10.

4. Penalties for non-delivery

Penalties for non-delivery of gas are required to preserve reliability on the system, and to avoid cost shifting to sales customers.[107] In its reply comments, Columbia defends its $75 per MCF for non-delivery. Columbia submits that the charge serves as a reasonable and important disincentive for non-deliveries or under-deliveries to residential customers, and it is necessary because of the drastic consequences of non-delivery or under-delivery. During recent years, gas prices have neared this level in other markets, tempting NGSs to re-route supply to those markets.[108]

Suppliers have mentioned penalties as a barrier to market entry and participation and suggested solutions to make penalties fairer:

- Penalties in supplier tariffs should be cost based.[109]
- Uniform penalties should be established across all NGDCs.[110]
- A band of tolerances over/under should be considered before a penalty takes effect.[111]
- Significant penalties should attach only during periods of critical gas supply.[112]

Alternatively, OSBA suggests a two-tier penalty structure for non-delivery could be adopted, with the higher penalty applicable only in the case of gaming.[113] EAP

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107 UGI Comments, p. 14.

108 Columbia Comments, p. 3.

109 Shipley Comments, p. 8; New Energy Comments, pp. 8-9.

110 OSBA Comments, pp. 5-6.

111 Dominion Retail Comments, p. 8.

112 Amerada Hess Comments, p. 8.

113 OSBA Comments, pp. 5-6.

opposes the proposed two-tiered no fault penalty system as unworkable because one would have to adjudicate intent or fault.[114]

Summation

Excessive penalties have been identified as a barrier to market participation by some suppliers. The rationale for assessing penalties for non-delivery and under-delivery is to deter gaming or arbitrage type behavior among suppliers. However, penalties that are in excess of reasonable costs expended by the NGDC may be anti-competitive and according to suppliers, present a barrier to supplier participation in an NGDC's territory. Varying penalties among NGDC systems also discourage a supplier from operating in more than one NGDC service territory and thus, the lack of a uniform penalty system acts as a barrier to suppliers who wish to participate in the retail market on a statewide basis.[115]

5. Price to Compare ("PTC") and Section 1307 Adjustment

Suppliers have identified two possible barriers to market entry and participation in regard to the pricing of natural gas by the NGDC. The first barrier involves the types of costs that have been omitted from an NGDC's PTC. The second barrier involves the quarterly adjustment of the PTC under the Section 1307(f) adjustment mechanism. These issues are discussed separately below.

[114] EAP Comments, p. 13.

[115] In *Shipley, infra.*, the Commission also directed that penalty charges should not be included in calculations of security amounts. Order at p. 11. *See* 52 Pa. Code §62.111 (relating to bonds or other security).

a. Fully Loaded PTC

The initial PTC was developed for each NGDC in the context of its restructuring proceedings.[116] Under Section 2203(3), 66 Pa. C.S. §2203(3), each NGDC was directed to address unbundling of commodity, capacity, balancing and aggregator services.

Suppliers identify the existing PTC as a barrier to market entry and supplier participation. At present, an NGS must compete with a price that reflects fully loaded gas costs against an NGDC's price that by rule reflects only an NGDC's pure gas costs; non-gas costs have been excluded.[117]

Suppliers argue that the PTC should include all costs related to gas supply function.[118] A fully loaded PTC rate would reflect uncollectible expenses, and the administrative cost of acquiring and administering PTC gas supplies.[119] The PTC must capture all the costs incurred in selling natural gas: the supply costs, the accounting costs, the regulatory costs, all of the overhead costs associated with selling the product, i.e., all

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[116] Application of Columbia Gas of Pennsylvania for Approval of a Restructuring Plan, Docket No. R-00994781; Application of Peoples Natural Gas Company for Approval of a Restructuring Plan, Docket No. R-00994782; Application of PG Energy, Inc. for Approval of a Restructuring Plan, Docket No. R-00994783; Application of Equitable Gas Company for Approval of a Restructuring Plan, Docket No. R-00994784; Application of National Fuel Distribution Corporation for Approval of a Restructuring Plan, Docket No. R-00994785; Application of National Fuel Distribution Corporation for Approval of a Restructuring Plan, Docket No. R-00994785; Application of UGI Utilities Inc. for Approval of a Restructuring Plan for its Natural Gas Division, Docket No. R-00994786; Application of PECO Energy for Approval of a Restructuring Plan for its Natural Gas Division, Docket No. R-00994787; Application of Penn Fuel Gas, Inc. for Approval of a Restructuring Plan, Docket No. R-00994788; Application of Carnegie Natural Gas Company for Approval of a Restructuring Plan, Docket No. R-00994789. On December 1, 1999, after its acquisition of Penn Fuel Gas and PFG Gas, PPL Gas filed an application for a restructuring plan at Docket No. R-00994788.

[117] Shell Energy Comments, p. 4.

[118] Dominion Retail Comments, pp. 2, 10-11.

[119] UGI Comments, p. 16.

customer care costs, including bad debt and customer care migration expenses.[120] These costs, which are currently bundled in the distribution rate, should be split out and should be recovered in the Section 1307(f) adjustment mechanism. In other words, proper unbundling should be performed to reflect these costs in the PTC.[121]

In regard to charges that belong more appropriately in the PTC rather than the distribution rate, more costs should be included in the PTC than in the base rate. OCA's concern is that the non-gas costs will wind up in both the PTC and the distribution rates, and OCA wants to prevent customers from paying for those same charges twice.[122]

One NGDC, Dominion Peoples, does not oppose the idea of a fully loaded PTC, but argues that these costs which are currently included in distribution rates must be done in the context of an NGDC base rate case..[123] UGI, however, claims that a rulemaking could flesh out the details of a fully loaded PTC pursuant to 66 Pa. C.S. §2203(3).[124]

b. Section 1307(f) Adjustment Mechanism

Suppliers have identified the quarterly adjustment of an NGDC's PTC using the Section 1307(f) process as a market barrier for both suppliers and customers.

Under Section 1307(f)(1)(ii), an NGDC may file a tariff with the Commission that provides for regular adjustment, but not more frequently than monthly, to its rates for

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[120] Shell Energy Testimony, Tr. 44; Direct Energy Comments, p. 5.

[121] Shell Energy Testimony, Tr. 45.

[122] OCA Testimony, Tr. 78-79.

[123] Dominion Peoples' Reply Comments, pp. 5-6.

[124] UGI Comments, p. 16.

natural gas sales. In Section 1307, "gas costs" are defined as the "direct costs" paid by an NGDC for the purchase and delivery of natural gas to its system in order to supply customers and may include costs paid under agreements to purchase natural gas, costs paid for transporting natural gas to its system, costs paid to storage service from others, all charges, fees, taxes and rates paid in connection with such purchase, pipeline gathering, storage and transportation and costs paid for employing futures, options and other risk management tools. 66 Pa. C.S. §1307(h) (relating to definition).

As to being anticompetitive, the suppliers explain that the Section 1307 adjustment mechanism has a detrimental effect on marketing.[125] The mechanism creates a lag so that customers are never really aware of the true cost of gas that they use. For example, an NGS gave an example where one NGDC made an interim adjustment to its gas cost rate, lowering it by $2.00 per MCF. The timing coincided with Shipley's offer of a fixed rate for one-year. Customers chose to receive service from the NGDC because the rate looked like the better deal, but ended up paying more when the NGDC increased its gas cost significantly during the heating season. Shipley's one-year contract price was $7.25 while the NGDC charged $7.46 and then $8.33 during the heating season.[126]

At present, customers only see an artificial price that does not change often. Consequently, the price of the forecasting error, *i.e.,* the 4% interest rate that customers pay to NGDCs on under collections, is hidden from customers who pay it.[127] The quarterly adjustment perpetuates the myth that the NGDC is supplying a fixed price service. The use of the adjustment mechanism creates a price that is a projection of future gas prices, is reconcilable on a dollar for dollar basis, and most certainly is not a

[125] Shipley Comments, p. 9.

[126] Shipley Comments, pp. 2-3.

[127] Suppliers' Joint Reply Comments, pp. 2-3.

fixed price, but rather a variable price.[128] The price never represents in a current period the actual price a customer pays for a given volume of gas.[129]

Thus, NGSs believe the PTC, as adjusted quarterly through the Section 1307(f) process fails to send the proper price signals to customers. To encourage competition in Pennsylvania, customers should be able to see and respond to price signals. Utility pricing must be able to fluctuate with current market conditions and do so on a timely basis.[130]

Moreover, suppliers state that they are disadvantaged in their marketing efforts because the PTC is presented to the market as an annual gas cost, which implies that it is fixed for one year, but in reality, it is a variable rate.[131] This means the average PTC is at least $1/MCF too low and the NGSs are competing against an artificially low price. NGDCs should explain that their PTC is not fixed and if gas costs are adjusted upward upon reconciliation, the consumer will pay more later.[132]

NGSs also assert that by underestimating their gas costs NGDCs can create below market PTCs. In fact, suppliers argue that there is an incentive to under-collect PTCs because NGDCs are allowed to collect interest from customers on under recoveries.[133]

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[128] *Id.*

[129] *Id.*

[130] NEMA Comments, pp. 3-4.

[131] Dominion Retail Comments, p. 2.

[132] Dominion Retail Comments, p. 3.

[133] Shipley Comments, p. 9.

More importantly, they argue that economic prudence demands that the NGDCs err, if at all, by underestimating those gas costs to avoid the 6% over collection penalty.[134]

OCA and the NGDCs oppose changing the PTC rate to a monthly adjustable rate. OCA states that the intent of the Competition Act was to provide benefits to consumers by introducing retail choice to Pennsylvania, not to harm them by increasing natural gas cost rates and volatility or diminishing service and reliability.[135]

EAP argues that the current statutory system of annual purchased gas cost rates with quarterly adjustments reflects a reasonable balance among the possible approaches. In theory, there are a range of possible ways to establish an initial PTC rate, and its adjustments. However, no evidence was presented during the Investigation that a change to the quarterly adjustments would provide a benefit to consumers.[136]

T.W. Phillips points out that NGDCs are subject to annual gas cost purchase proceedings and are required to use least cost procurement strategies to procure supply so that annual purchased gas cost proceedings assure competitive gas costs for purchases of merchant service. Also, T.W. Phillips states that no regulatory protections are available to gas supply customers from NGSs.[137]

Suppliers have offered numerous suggestions to address their concerns regarding the Section 1307(f) process. Chief among these is the monthly adjustment of an NGDC's PTC so as to more closely reflect the market price of natural gas supply.[138] In its

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134 Shell Energy Comments, pp. 3-4; Suppliers' Joint Reply Comments, p. 4.

135 OCA Comments, p. 6.

136 EAP Reply Comments, p. 7.

137 T.W. Phillips Reply Comments, p. 5.

138 Shipley Comments, p. 6; Shell Energy Comments, pp. 3-4; NEMA Comments, pp. 3-4; Dominion

comments, NEMA acknowledges that the law requires a fixed rate option if adjustments are made on a less than quarterly basis. 66 Pa. C.S. §1307(f) (1)(ii). NEMA opposes this because the addition of a fixed rate price will confuse consumers.[139] On the other hand, UGI suggests that NGDCs could voluntarily offer a non-reconcilable fixed rate option as it would more closely resemble NGS monthly offerings.[140] OCA opposes the idea of monthly adjustments of PTC to market.[141]

Other suggestions from suppliers include the following:

- The NGDCs would post a rolling twelve-month average market price with the monthly PTC.[142]
- NGDC system sales of supply gas could be made non-reconcilable.[143]
- NGDCs could move to a monthly price system that would require only minimum reconciliation.[144]
- The Commission could create incentives for the NGDCs to minimize price lags by limiting under/over collection adjustments to no more than .25 /MCF. [145]
- PTC should be market-based and tied to a published and credible index such as the NYMEX that closes at least one month in advance of the current month.[146]

Retail Comments, p. 9; Suppliers' Joint Reply Comments, pp. 5-6.

139 NEMA Comments, pp. 3-4.

140 UGI Comments, p. 14.

141 OCA Comments, pp. 6, 23.

142 Shipley Comments, p. 9.

143 Dominion Retail Comments, pp. 2-3.

144 Dominion Retail Comments, p. 6.

145 *Id.*

146 OCA opposes the idea of using another index like the NYNEX index to make the adjustment. OCA Testimony, Tr. 77.

This would permit suppliers to market against a known formula and allows utilities time to prepare to allow for customer migrations.[147]

- The Section 1307(f) adjustment process should provide over- or under-collections or other supply related costs that are attributable to the period prior to migration to avoid any potential double charging or recovery of such charges.[148]

Summation

While Pennsylvania's retail natural gas market was implemented in accordance with the Competition Act, the resulting competition may be best described in traditional economic terms as a "price leader" type of oligopoly where the actions of one seller influence the price and the subsequent actions of other sellers in the market. In this instance, the NGDC establishes the PTC -- the benchmark price against which NGSs are obliged to compete. When the PTC is adjusted, the suppliers must adjust their price to compete against that NGDC. The existence of such an oligopoly situation alone supports the conclusion that effective competition does not exist in the retail natural gas market.

Because the NGDC's PTC does not include all of the costs of gas supply acquisition, the PTC may represent an artificially low price, making it difficult for NGSs to compete against the NGDCs for customers. Moreover, the quarterly adjustment of the PTC through the Section 1307(f) process creates a lag in recognizing increased gas costs so that customers are confused as to the actual cost of natural gas over the long run. The customers believe to their detriment that the NGDCs are offering an annual fixed rate when it is really a variable cost service with quarterly true-ups. These practices involving

[147] NEMA Comments, pp. 3-4.

[148] *Id.*

natural gas pricing make it difficult for suppliers to compete against the NGDCs for customers.

Accordingly, the manner in which the PTC was formulated and is adjusted to correct over- or undercollections through the Section 1307(f) process constitutes a barrier to supplier participation in the retail natural gas market. The PTC and the quarterly adjustment mechanism should be re-examined to encourage increased competition.

C. Barriers to Customer Participation

Commenters have raised several issues that might represent barriers to customer participation in the retail natural gas service supply market. Chief among them is the NGDC's PTC rate and Section 1307(f) quarterly adjustment mechanism that insulates customers from knowing the actual cost of gas and perpetuates the notion that the NGDCs are offering an annual fixed rate for natural gas supply.[149]

Suppliers believe that the current system masks the price of gas so customers have no good information on which to base decisions on their consumption. The suppliers make reference in footnote 1 of their Joint Reply Comments to Report of the Government Accounting Office "Electricity Markets: Consumers could benefit from Demand Programs but Challenges Remain," (August 2004, GAO-04-844) from http://www.gao.gov/new.items/d04844.pdf. The report finds that one of the most significant hindrances to demand programs in electric markets is regulated prices that mask market costs from customers.[150]

[149] In *Dominion Retail, Inc. v Pa. PUC*, 831 A. 2d 810 (Pa. Cmwlth. 2003), Commonwealth Court affirmed the Commission's order that Equitable's fixed sales service (FSS) Rate does not have to be reconciled under Section 1307(f), 66 Pa. C.S. §1307(f). Rate FSS is available for residential and small business customers and provides them with the option of locking in the price for natural gas service for one year.

[150] Suppliers' Joint Reply Comments, pp. 2-3.

To encourage competition in Pennsylvania, NEMA suggests that customers should be able to see and respond to price signals. Utility pricing must be able to fluctuate with current market conditions and do so on a timely basis.[151]

NEMA also suggests that besides more accurate and immediate information about market price, customers need additional consumer education regarding the benefits of shopping for alternative suppliers. NEMA also believes that NGSs should be involved in developing educational messages about the availability of natural gas supply through alternative suppliers.[152] Dominion Peoples disagrees, and states that although the initial education program was successful, there are diminishing returns from further large scale campaigns.[153]

Dominion Retail comments that customer enrollment should be more uniform and efficient to allow for customers to change suppliers.[154] Direct Energy supports providing advance information about contract renewals to customers so they can make informed decisions about selecting a new supplier but would eliminate the 60- and 90-day notice requirement.[155]

In addition to consumer education, some suppliers would like to be more involved in customer care service, especially in providing seamless service transfer when a customer moves. Currently, NGSs are not allowed to continue serving customers through

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[151] NEMA Comments, pp. 3-4.

[152] NEMA Comments, p. 6.

[153] Dominion Peoples Comments, pp. 10-11.

[154] Dominion Retail Comments, pp. 9-10.

[155] Direct Energy Testimony, Tr. 29-30.

the move process, and are not allowed to act as the agent for the customer in contacting the NGDC and arranging for the move and continuation of the NGS's service. Shipley explains that ten percent of its customers move every year.[156] Value may be added to the contract by insuring a customer a seamless transfer of service to a new home.[157]

Summation

According to suppliers, the lack of accurate and immediate information about the true costs of natural gas (price signals) acts as a barrier to broader customer participation in the natural gas supply marketplace. Also, the inability of a supplier to continue a contract with a customer who moves during the term of a contract may also represent a barrier to customers' continuing participation in the market.

Convincing evidence has not been offered that lack of general consumer education programs about choosing an alternative supplier presents a barrier to customer participation in the retail market. However, the need for additional consumer education along with other customer service and information issues may need to be re-visited depending on changes that are made to the statewide retail market to increase supplier participation and competition.

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[156] Shipley Testimony, Tr. 47.

[157] Shipley Testimony, Tr. 48.

VI. FINDINGS

Consistent with Section 2204(g), the Commission presents the following findings:

(1) The Pennsylvania natural gas industry was restructured in accordance with the Natural Gas Choice and Competition Act, 66 Pa. C.S. §§2201, *et seq.*

(2) Since the enactment of the Competition Act, there has been little to no change in the throughput of competition volumes. In 1999, approximately 50% of the gas flowing in Pennsylvania was under a competitive tariff. In 2004, the volume was approximately 47.5%.

(3) Early in 1999 the average number of NGSs serving in each NGDC territory was just over 20. That number has dropped to 10 NGSs per NGDC in the fourth quarter of 2004.

(4) The number of customers obtaining supply from alternative natural gas suppliers was at an all time high in the second quarter of 1999. That high mark was 321,539. By the fourth quarter of 2004, that number had fallen to 208,849.

(5) Although there are levels of competition on three NGDC systems in western Pennsylvania, this competition pre-dates the Competition Act and came about as a result of Commission-approved pilot programs on those systems. Since 2001, competition on these three systems has decreased by 20 percent.

(6) NGS security requirements are established by each natural gas distribution company and differ between companies. 66 Pa. C.S. §2208 (c)(i).

(7) According to suppliers, the amount or form of security required by an NGDC acts as a substantial barrier to entry and participation by an NGS in an individual NGDC service territory.

(8) According to suppliers, the differing security requirements among NGDCs act as a substantial market barrier to NGS entry, and participation in marketing natural gas supply service in multiple NGDC service territories.

(9) Penalties for non-delivery or under delivery of natural gas by a NGS vary by NGDC and for the most part, these penalties are not cost-based.

(10) According to suppliers, the differing penalties among natural gas distribution companies act as a substantial barrier to NGS entry and continued participation

in marketing retail natural gas supply service in multiple NGDC service territories.

(11) Capacity assignment to NGSs is mandatory under 66 Pa. C.S. §2204 (d)(4)) and according to suppliers, acts as a barrier to supplier participation.

(12) An NGDC's Price to Compare ("PTC") establishes the retail market price for natural gas against which NGSs must compete for customers and sales in the NGDC's distribution territory. A change in an NGDC's PTC causes a change in the retail market price of gas against which suppliers must compete for sales and customers.

(13) NGDC's gas rates are adjusted on a quarterly basis, pursuant to 66 Pa. C.S. §1307(f), and subsequently lags behind the true cost of natural gas.

(14) An NGDC's natural gas distribution rate includes costs of natural gas supply procurement that should be recognized in the NGDC's PTC.

(15) Customers are not provided with accurate or timely information regarding the true cost of natural gas supply service because of the price lag associated with quarterly true-ups pursuant to the Section 1307(f) adjustment mechanism and the omission of some natural gas commodity procurement costs from the PTC. These commodity procurement costs are instead included in the NGDC's distribution rate.

(16) There is not "effective competition" in Pennsylvania's retail natural gas supply service market on a statewide basis.

VII. CONCLUSION

In this report, the Commission has adopted what it believes is a reasonable and workable definition of "effective competition" for this Investigation. It is a descriptive definition that lists certain aspects of the market structure and operation that are indicia of "effective competition" in that market:

(1) Participation in the market by many sellers so that an individual seller is not able to influence significantly the price of the commodity;
(2) Participation in the market by many buyers;
(3) Lack of substantial barriers to supplier entry and participation in the market; and
(4) Lack of substantial barriers that may discourage customer participation in the market.

Using this definition as a standard and giving appropriate weight[158] to the data, the comments and testimony submitted by participants, the Commission made sufficient findings regarding the realities of Pennsylvania's retail natural gas supply service market:

- The record demonstrates a lack of participation by many natural gas buyers and sellers in the retail natural gas supply services market on a statewide basis.
- The record indicates that natural gas distribution companies tend to act as price leaders in their respective service territories because many customers are not aware that the commodity price of natural gas, i.e. the Price to Compare or PTC, is a quarterly reconcilable price, based on projections, rather than a fixed annual price.
- According to suppliers, substantial barriers to entry in the retail natural gas supply market exist because of differing security requirements among natural gas distribution companies.
- According to suppliers, substantial barriers to entry and continued participation by natural gas suppliers in the retail natural gas service supply market exist as the result of the omission of procurement costs from the natural gas distribution company's commodity price of natural gas (PTC).

[158] The statistical data submitted by NGDCs demonstrates low numbers of suppliers actually participating in Pennsylvania's retail market. Because a competitive market needs to attract and retain competitors, it is appropriate to give additional weight to the comments and the testimony of suppliers regarding the existence and magnitude of barriers that have caused them to make business decisions to forgo the Pennsylvania market. *See* IV. (f): "Methodology," *supra.*, pp. 26-27.

- According to suppliers, substantial barriers to supplier participation in the retail natural gas supply market exist because of penalties placed on suppliers that vary among natural gas distribution companies systems and that are not cost-based.
- The regulatory lag in the establishment and implementation of quarterly price adjustments by natural gas distribution companies tends to mask the current market price of natural gas.
- The marketplace lacks accurate and timely price signals; as a result, the market cost of natural gas supply service offered by natural gas distribution companies is not communicated immediately to customers.

Based on the factors we have adopted to consider whether "effective competition," exists for purposes of Section 2204(g), these findings support the ultimate conclusion that there is a lack of "effective competition" in Pennsylvania's retail natural gas supply market at this time.

In light of this conclusion, pursuant to 66 Pa. C.S. §2204(g), the Commission determines that there is a need to convene the Stakeholders to consider an integrated solution to enhance competition in the statewide retail natural gas supply services market. The Stakeholders shall examine the below listed issues and other relevant matters that are identified in this report or by Stakeholders, and make recommendations regarding any changes that need to be made to the market's structure and operation to encourage increased participation by NGSs and customers. These issues include:

A. SECURITY. Excessive security and restrictive forms of security accepted by NGDCs and lack of uniformity of security requirements hinder supplier entry and market participation.

B. MANDATORY CAPACITY ASSIGNMENTS. Mandatory capacity assignment acts as a market barrier.

C. NOMINATION AND DELIVERY REQUIREMENTS. Restrictive nomination and delivery requirements that varied among NGDCs discourage supplier participation in the market.

D. PENALTIES FOR NON-DELIVERY. Excessive penalties and lack of uniformity between NGDC systems act as barriers to supplier participation in the statewide retail market.

E. PRICE TO COMPARE. Inclusion of all costs related to natural gas supply procurement as a means of increasing supplier participation in the statewide retail market.

F. PRICING INFORMATION AND CONSUMER EDUCATION. Lack of timely price signals act as a barrier to customer participation. Additional consumer education may be needed in light of changes that may be made to the market.

G. SEAMLESS MOVE: Lack of portability of competitive supply service for a retail customer moving from one location to another within the same service territory discourage customer participation.

H. RECEIVABLES FOR MASS MARKET CUSTOMERS. Institution of a reasonably priced NGDC "purchase of receivables" policy as an interim mechanism to promote choice for customers. Use of a "bad debt tracker" to ensure NGDC recovery of bad debt expense in conjunction with purchase of receivables.

I. ACQUISITION COSTS FOR MASS MARKET: Use of Opt-Out Municipal Aggregation, increased availability of customer lists and customer assignment programs to lessen the high cost to NGSs of acquiring mass market customers.

J. SUPPLIER CONSOLIDATED BILLING: Availability of Supplier Consolidated Billing as an important tool for advancing NGS-customer relationships.

K. SUPPLIER TARIFF REQUIREMENTS: Uniform supplier tariff rules, including those provisions related to customer enrollment, to encourage supplier participation statewide.

L. CONSUMER PROTECTION RULES. Revision of some requirements, particularly customer notice requirements, that create additional costs for NGSs.

M. NGDC CONSOLIDATED BILLING: Exclusive NGDC consolidated billing limitations restrictions NGSs in their ability to communicate effectively with consumers.

N. NGDC PROMOTION OF COMPETITION: Use of incentives for NGDC incentives to promote competition with a corresponding ban on the marketing of SOLR service by NGDC.

O. SUSTAINED COMMISSION LEADERSHIP IN COMPETITIVE MARKETS: The need for a supplier Ombudsman to increase Commission responsiveness to supplier issues.

P. NGDC NEGOTIATED SUPPLY CONTRACTS: Possible elimination of special negotiated contracts or agency agreements between customers and NGDCs.

Q. MARKET INFORMATION: The cost for daily consumption information and data accuracy issues and availability of daily customer usage or utility operating and transportation discount information create barriers for NGS participation.

R. CODE OF CONDUCT: Lack of reporting, auditing or enforcement of the Code of Conduct, especially in regard to certain communications between an NGDC and its unregulated affiliates.

S. SWITCHING RESTRICTIONS: Lag in NGDCs implementation of customer switching suppliers.

T. SERVICE TO LOW INCOME CONSUMERS. Remove of obstacles to provide competitive retail service to low income customers.

Also, the Stakeholders shall recommend any legislative amendments, if any, that need to be made regarding the Natural Gas Choice and Competition Act and the Public Utility Code and revisions that should be made to applicable Commission regulations to facilitate their recommendations to enhance competition in the statewide retail natural gas supply services market.

The Commission acknowledges that it may already have the legal authority to implement some of the solutions that have been proposed commenters in this investigation, such as the recognition in the distribution company's PTC of all natural gas procurement costs in a NGDC base rate case[159] and the further unbundling of specific services such as billing or metering through a rulemaking.[160] However, based on past experience, the Commission believes that an integrated solution that is developed by all interested parties and addresses all relevant substantive and procedural issues is preferable to a piecemeal approach to market climate improvement.

The Commission anticipates that the first stakeholder meeting will be held this Fall 2005 and that the group's work will be completed by the end of 2005.

[159] 66 Pa. C.S. §2203 (11).

[160] At present, the Commission may address unbundling of other services only through the rulemaking process. 66 Pa. C.S. §2203(3)(relating to standards for restructuring the natural gas industry). Because rulemakings can be a two year process, it may be possible for the stakeholders to agree to the use of a different, more expedient Commission proceeding that would still afford all parties due process.

APPENDIX

Investigation into Competition in the Natural Gas Supply Market,
Order entered May 28, 2004 at Docket No. I-00040103

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting held May 27, 2004

Commissioners Present:

Terrance J. Fitzpatrick, Chairman
Robert K. Bloom, Vice Chairman
Glen R. Thomas
Kim Pizzingrilli
Wendell F. Holland

Investigation into Competition in the Natural Gas Supply Market

Docket No. I-00040103

ORDER

BY THE COMMISSION:

Section 2204(g) of the Natural Gas Choice and Competition Act requires the Commission to initiate an investigation or other appropriate proceeding to determine whether effective competition for natural gas supply services[1] exists in the Commonwealth.[2] The proceeding must be launched five years after the effective date of the Natural Gas Choice and Competition Act. The Act became effective July 1, 1999.

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[1] The term "natural gas supply services" is defined as (1) the sale or arrangement of the sale of natural gas to retail gas customers; and (2)services that may be unbundled by the Commission under section 2203(3) (relating to standards for restructuring of the natural gas utility industry.) 66 Pa. C.S. §2202.

[2] **§ 2204(g) Investigation and report to General Assembly**

Five years after the effective date of this chapter, the commission shall initiate an investigation or other appropriate proceeding, in which all interested parties will be given a chance to participate, to determine whether effective competition for natural gas supply services exists on the natural gas distribution companies' systems in this Commonwealth. The commission shall report its findings to the General Assembly. Should the commission conclude that effective competition does not exist, the commission shall reconvene the stakeholders in the natural gas industry in this Commonwealth to explore avenues, including legislative, for encouraging increased competition in this Commonwealth.

66 Pa. C.S. § 2204(g).

Thus, we must initiate our investigation on, or shortly after July 1, 2004 to comply with the directive of the General Assembly. With this order, we initiate this investigation.

The purpose of the investigation is to determine the level of competition that exists currently in the natural gas supply service market in Pennsylvania. A party that wishes to submit written testimony shall file ten copies of his or her written testimony at this docket with the Commission's Secretary no later than Friday, August 27, 2004. An electronic copy of the testimony on a diskette must also be provided so that testimony can be posted at the Commission's website.

Parties are asked to address the following topics in their written testimony:

1. The assessment of the level of competition in Pennsylvania's natural gas supply service market.
2. The effect of the price of natural gas on competition.
3. The effect of consumer education on competition.
4. The effect of customer information/service on competition.
5. The effect of supplier financial security requirements on competition.
6. The effect of natural gas distribution company penalties and other costs on competition.
7. Discuss any avenues, including legislative, for encouraging increased competition in Pennsylvania.

Note that the list of topics is not all inclusive. Other topics that are relevant to assessing competition in the Pennsylvania natural gas supply service market may also be addressed.

Additionally, the Commission will direct all natural gas distribution companies and licensed natural gas suppliers to provide the information requested in Annex A. The receipt of this current and historical data should provide a more accurate and complete picture of competition in the Pennsylvania market.

Following receipt of the written testimony, the Commission will hold an *en banc* hearing to further explore the level of competition in Pennsylvania. The *en banc* hearing will be held on September 30, 2004. The Commission will issue a Secretarial Letter addressing further procedural details for this hearing on or before September 10, 2004. The Commission wishes to remind interested parties are invited to contribute other relevant data and statistics related to this investigation; **THEREFORE,**

IT IS ORDERED:

1. That an investigation into competition in Pennsylvania's natural gas supply service market is initiated.

2. That a copy of this order shall be served upon all Pennsylvania natural gas distribution companies, the Philadelphia Gas Works, the Office of Consumer Advocate, the Office of Small Business Advocate, all licensed natural gas suppliers, the Energy Association of Pennsylvania, the Independent Oil and Gas Association and the Industrial Energy Consumers of Pennsylvania.

3. That a person wishing to submit written testimony addressing the issues presented in this order shall do so no later than August 27, 2004. An original and ten (10) copies of the written testimony and one diskette containing an electronic version of the written testimony shall be filed with the Commission's Secretary. Testimony should be addressed to James J. McNulty, Secretary, Pennsylvania Public Utility Commission, P.O. Box 3265, Harrisburg, PA 17105-3265.

5. That the natural gas distribution companies, the Philadelphia Gas Works, and the natural gas companies shall file the answers to the questions appearing in Annex A shall be filed no later than August 27, 2004. An original and ten copies of the answers

and an electronic version of the answer on a diskette shall be filed with the Commission's Secretary.

6. That an *en banc* hearing will be held on September 30, 2004. The Commission will issue a Secretarial Letter addressing the procedural aspects for this hearing on or before September 10, 2004.

7. That the contact persons for this investigation are; Robert Bennett, Fixed Utility Services at 717- 787-5553 (robennett@state.pa.us) and Patricia Krise Burket, Assistant Counsel at (717) 787-3464 (pburket@state.pa.us).

8. That this Order shall be published in the *Pennsylvania Bulletin* and that the Order and the written testimony submitted shall be posted at the Commission's website at www.pucpaonline.com.

BY THE COMMISSION:

James J. McNulty,
Secretary

(SEAL)

ORDER ADOPTED: May 27, 2004

ORDER ENTERED: May 28, 2004

ANNEX A

Natural Gas Distribution Companies

Each natural gas distribution company is directed to provide specific information about its system.

(1) For each quarter of the years 1999 to 2004, provide the following:
  (a) Number of natural gas suppliers operating on its distribution system;
  (b) Number of residential, industrial and commercial customers purchasing gas from alternative suppliers;
  (c) Volume of natural gas transported on its distribution system;
  (d) Volume of natural gas transported for suppliers on its distribution system.
  (e) Numbers of customer complaints/disputes regarding slamming or unauthorized change of supplier; changing a supplier; selecting a supplier; confusion regarding a bill on which charges appear for natural gas from an alternative supplier, error in billing for a supplier; and any other issue competition-related issue.

(2) Provide the following information about security requirements that natural gas suppliers are required to maintain for licensure (66 Pa. C.S. § 2208(c)(1)(i)):
  (a) Security requirement as posted in the distribution company's initial supplier tariff.
  (b) Each change that was made to this security requirement to date.

Natural Gas Suppliers

Natural gas suppliers are directed to provide specific information regarding sales volume and customer number. For each of the quarters of the years 1999 to 2004, provide the following:

(1) Number of customers (by class) for each distribution system on which the supplier operates.
(2) Volume of natural gas delivered to customers (by class) on each system on which the supplier operates.
(3) Numbers of customer complaints/disputes regarding slamming or unauthorized change of supplier; changing a supplier; selecting a supplier; confusion regarding a bill on which charges appear for natural gas from an alternative supplier, error in billing for a supplier; and any other issue competition-related issue.

PENNSYLVANIA
PUBLIC UTILITY COMMISSION
Harrisburg, PA 17105-3265

Public Meeting held September 11, 2008

Commissioners Present:

James H. Cawley, Chairman
Tyrone J. Christy, Vice Chairman
Robert F. Powelson
Kim Pizzingrilli, Statement attached
Wayne E. Gardner

Investigation into the Natural Gas Supply Market: Report on Stakeholders' Working Group (SEARCH); Action Plan for Increasing Effective Competition in Pennsylvania's Retail Natural Gas Supply Services Market	Docket No. I-00040103F0002

FINAL ORDER

AND

ACTION PLAN

BY THE COMMISSION:

In its *Report to the General Assembly on Pennsylvania's Retail Natural Gas Supply Market* (*Report to the General Assembly*), issued October 2005, the Pennsylvania Public Utility Commission (Commission) determined that effective competition did not exist in Pennsylvania's retail natural gas market. As a result of this determination, the Commission was required by law to convene the Natural Gas Stakeholders Group to explore avenues for increasing competition. *See* 66 Pa.C.S. § 2204(g) (relating to implementation; investigation and report to the General Assembly).

The purpose of this order is (1) to formally release the report documenting the work of the Natural Gas Stakeholders Working Group; and (2) to set forth and initiate an Action Plan that will increase effective competition in the retail market for natural gas supply services.

DISCUSSION

Background

As a result of the Commission's *Investigation into the Natural Gas Supply Market*[1], undertaken five years after the enactment of the *Natural Gas Choice and Competition Act* (*Act*) in 1999, the Commission determined that there was not "effective competition" in Pennsylvania's retail market for natural supply. *See Report to the General Assembly.*[2] For purposes of the report and this order, "effective competition" was defined as:

- Participation in the market by many sellers so that an individual seller is not able to influence significantly the price of the commodity.
- Participation in the market by many buyers.
- Lack of substantial barriers to supplier entry and participation in the market.
- Lack of substantial barriers that may discourage customer participation in the market.
- Sellers are offering buyers a variety of products and services.

Report to the General Assembly, p. 25.

The Commission's determination that effective competition did not exist was based on the lack of participation of an adequate number of natural gas suppliers and customers in the retail natural gas market, and the identification of substantial barriers in the market structure and operation that prevented or discouraged the participation of these groups in the market.

[1] Docket No. I-00040103.
[2] *The Report to the General Assembly* was released on October 6, 2006 and may be accessed at http://www.puc.state.pa.us/PcDocs/570097.pdf.

Because of the Commission's determination that retail competition did not exist, the *Act* required the Commission to convene an industry-wide stakeholders group to explore avenues, including legislative, for encouraging increased participation in Pennsylvania's retail natural gas supply market. *See* 66 Pa.C.S. § 2204(g) (relating to implementation – investigation and report to the General Assembly). The Natural Gas Stakeholders Working Group, subsequently christened "SEARCH[3]," first met on March 30, 2006.

Four subgroups were established to study related issues that had been identified in the *Report to the General Assembly* as being substantial barriers to competition. *See Report to the General Assembly*, pp. 67-69. Some issues were assigned to more than one subgroup so that certain aspects of the same issue could be examined from different perspectives. These subgroups with their assigned subject matter are listed below:

I. INTER-COMPANY ACTIVITY (IA) SUBGROUP

Issues assigned to the subgroup included: Security; Mandatory Capacity Assignments; Nomination and Delivery Requirements; Penalties For Non-Delivery; Purchase Of Receivables For Mass Market Customers; Supplier Tariff Requirements; Market Information; Switching Restrictions

II. CUSTOMER INTERFACE (CI) SUBGROUP

Issues assigned to the subgroup included: Pricing Information and Consumer Education; Seamless Move; Aggregation/Assignment; Supplier Consolidated Billing; Consumer Protection Rules; Barriers to Customer Participation; NGDC Consolidated Billing; Service To Low Income Consumers

[3] SEARCH is an acronym for "Stakeholders Exploring Avenues for Removing Competition Hurdles."

III. COST OF SERVICE (CS) SUBGROUP

Issues assigned to the subgroup included: Costs of Retail Supply Service; Financial Incentives for Energy Efficiency; Purchase of Receivables for Mass Market Customers; Fixed Price Option

IV. COMPETITION MONITORING (CM) SUBGROUP

Issues assigned to the subgroup included: NGDC Promotion of Competition; Sustained Commission Leadership in Competitive Markets; Code of Conduct; NGDC Negotiated Supply Contracts; Aggregation/Assignment Programs

The subgroups were facilitated by Commission staff and involved stakeholders from all segments of the industry – residential, commercial and industrial customers, suppliers, natural gas distribution companies and pipelines[4].

An additional subgroup was established after the collaborative began meeting. This subgroup examined issues relating to the possible abandonment of the merchant function by natural gas distribution companies and the development of a supplier of last resort model. Also, the working group, as a whole, discussed the various overlapping issues.

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[4]UGI Utilities, Inc.; UGI Corporation; PECO Energy Company; Suburban Energy; Vectren Retail LLC; T.W. Phillips Gas and Oil Company; Stand Energy; Philadelphia Gas Works (PGW); PG Energy; Pepco Energy Services; Office of Consumer Advocate; NRG Energy Center – Pittsburgh; Shipley Energy; NiSource Corporate Services Company; MX Energy; Mack Services Group; Yvonne Zanos, Consumer Editor, KDKA; Independent Oil and Gas Association of Pennsylvania (IOGA-PA); Amerada Hess Corporation (Hess); Exelon Corporation; Energy Association of Pennsylvania (EAPA); Equitable Gas Company; Duke Energy; Dominion Peoples; Usher Fogel, Esq.; Constellation New Energy- Gas Division; Direct Energy; Linn Energy, LLC; National Fuel Gas Distribution Company; National Fuel Resources, Inc.; Columbia Gas of PA, Inc.; Industrial Energy Consumers of Pennsylvania (IECPA), *et al.*; ABARTA Oil & Gas Company; T and F Exploration, L.P.; Agway Suburban Energy; Dominion – Retail Inc.; The Peoples Natural Gas Company; PA AFL-CIO Utility Caucus; Agway Energy Services, LLC; Thermal Ventures II, LP; Pennsylvania Economic Development Association; Interstate Gas Supply, Inc.; Borough of Chambersburg, PA; South Jersey Energy Company; Exelon Business Services Company; National Energy Marketers Association; Texas Eastern Gas Transmission; and Columbia Gas Transmission. OSBA filed a statement that the lack of resources prevented its full participation in the working group.

SEARCH REPORT

The work of the subgroups was documented by Commission staff. Stakeholders were provided with interim summaries of the subgroups' discussions and were permitted to critique, revise and comment on the drafts. From these interim summaries, Staff prepared a final report on the activities of the SEARCH collaborative, which we are formally releasing with this order (*SEARCH Report*)[5].

The *SEARCH Report* summarizes the work and discussions of the Stakeholders, devoting a section to each proposal, program, mechanism or practice that was examined. Each section defines the subject, states the positions of the participants, identifies the requisites for implementation, analyzes the impact on effective competition and discusses the disadvantages and costs of implementation. The report does not attempt to fully address all aspects of each issue that may have been raised during the working group discussions, and does not make any recommendation regarding the solutions presented. Instead, the *SEARCH* Report was written as a fair and neutral summary of the various barriers to market entry and participation for suppliers and of the possible solutions that might be implemented to increase effective competition in the retail market. In this order, we have cross-referenced applicable sections of the *SEARCH Report* in discussing the solutions that we have selected for further action.

ACTION PLAN

We have reviewed the *SEARCH Report* and have determined that, consistent with the pro-competition legislative policy embodied in the Act and the information contained in the *SEARCH Report*, our efforts to increase effective competition in the retail natural gas market should begin now and, furthermore, should be concentrated on changing the

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[5] The draft *SEARCH Report* was posted for public access on May 21, 2008 at http://www.puc.state.pa.us/PCDOCS/1012492.doc.

market structure and its operation to reduce or eliminate barriers to supplier entry and participation. In our judgment, increasing the number of suppliers and, in time, the variety of service offerings available in the marketplace would be expected to attract customers to the market.

In its 2005 *Report to the General Assembly*, this Commission expressed its belief that "an integrated solution [to increase supplier and customer participation] that is developed by all interested parties and addresses all relevant substantive and procedural issues is preferable to a piecemeal approach to market climate improvement." *Report to the General Assembly*, p. 69. We still believe this approach will provide the best possible solution.

Consistent with this approach, we are issuing this order that sets out an action plan to reduce barriers to entry and to change the structure and operation of the retail market in order to increase competition in natural gas supply. We have selected for action the programs, practices, rules and requirements whose modification would seem to offer the greatest potential to eliminate or reduce market barriers, and thereby increase supplier participation in the marketplace[6].

The Action Plan will be implemented in two phases.

Phase 1 will address the matters that the Commission is able to implement immediately to facilitate the development of a competitive market. These matters include creation of the Office of Competitive Market Oversight within the Commission, the

[6] In our judgment, customer participation will increase only if there are more suppliers offering a variety of products to attract customers to the market. For this reason, consumer information and education activities have been judged to be secondary matters that will be undertaken on an as needed basis, such as when changes are made to certain programs that could affect customer eligibility. Also, certain rule changes or new programs or policies that might increase customer participation, such as seamless moves, customer referral programs, and aggregation programs have not been recommended for implementation at this time. Discussion of these subjects may be found in the *SEARCH Report at* pp. 38-39, 39-43 and 55-58.

expansion of Purchase of Receivables programs, and the pursuit of legislative changes regarding capacity assignment/release.

Phase 2 will address those matters that require and are better handled by means of a rulemaking process before implementation. These rulemakings will address three (3) groups of issues: Natural Gas Distribution Company (NGDC) issues, Natural Gas Supplier (NGS) issues and business practices issues.

In the rulemaking regarding NGDC issues, the Commission will address rules for: Price to Compare formulation, reconciliation and quarterly adjustments, Purchase of Receivables Programs, mandatory capacity release and non-discrimination, and cost recovery of competition-related activities, and regulatory assessments.

In the rulemaking regarding NGS issues, the Commission will address rules for: creditworthiness of suppliers and reasonable security requirements.

Finally, in the rulemaking regarding business practices issues, the Commission will address rules for: standardization of NGDC system operating rules, specific operation rules regarding nomination and delivery requirements, tolerance bands and cash out/penalties, and standardization of electronic bulletin boards.

In terms of a time frame, in our opinion, a realistic time frame to complete this action plan would be two years from the date of this order. Also, we will accept the *SEARCH Report's* recommendation to conduct a formal milestone review to evaluate the Commission's progress in developing more competition in the retail market for natural gas supply in Pennsylvania. The review will be due five years from the entry date of this order.

PHASE 1 – MATTERS FOR IMMEDIATE COMMISSION ACTION

A. OFFICE OF COMPETITIVE MARKET OVERSIGHT

The subject of creating a Commission Office of Competitive Market Oversight (OCMO) to oversee the competition in the retail natural gas supply market was discussed by the SEARCH working group. The functions and activities of the OCMO would be necessarily broad in order to promote, facilitate, and guide the development of the retail market to achieve effective competition. The OCMO could act informally to facilitate disputes between a particular supplier and a NGDC, and also could intervene in a Commission proceeding, subject to due process requirements, to protect the public interest in regard to preserving, maintaining and increasing competition in the retail market. *SEARCH Report*, pp. 45-51.

As envisioned, the initial number of Commission staff permanently assigned to the OCMO would be small. As needed, other Commission staff could be temporarily assigned to the OCMO from the various bureaus depending on the circumstances. *SEARCH Report*, p. 49. Calling upon existing Commission staff to participate in proceedings for the purpose of advocating for the OCMO and the competitive market would not require additional resources, but rather a re-alignment of staff roles consistent with the objective of fostering competitive markets. *SEARCH Report*, p. 49.

In regard to the creation of the OCMO within the Commission, the NGDCs and NGSs disagree regarding the need for such an office and about its usefulness in promoting competition in the retail natural gas market. NGDCs state that Section 2204 (f) of the *Act* already provides for a company-specific collaborative process to discuss and resolve capacity and operational issues relating to customer choice. NGSs point out that the collaborative process can be cumbersome, and that those called pursuant to

Section 2204(f) do not offer a broad enough platform to resolve all types of competitive issues. *SEARCH Report*, p. 47.

Disposition

After review of the *SEARCH Report*, we find that it is in the public interest to establish an independent unit within the Commission to oversee the development and functioning of the competitive retail natural gas supply market. We have already expressed our intent to establish such an in-house unit in regard to the electric choice market in our Statement of Policy at 52 Pa. Code at § 69.1817 (relating to retail choice ombudsman). *See Policy Statement on Default Service and Retail Electric Markets*, Order adopted May 10, 2007 at Docket No. M-00072009.

In regard to the creation of such a unit, no change in legislation is necessary. Section 305(c) of the Public Utility Code authorizes the Commission to appoint, fix the compensation of, authorize or delegate such officers and employees as may be appropriate for the proper conduct of the work of the Commission. *See* 66 Pa.C.S. § 305 (c) (relating to director of operations, secretary, employees and consultants). Also, Section 308(f) allows the Commission to establish any additional bureaus that the Commission finds necessary to protect the interests of the people of Pennsylvania. *See* 66 Pa.C.S. § 308(f) (relating to bureaus and offices; other bureaus and offices). Accordingly, the Commission may establish an independent unit, and may direct and assign current staff to the unit on a permanent or temporary basis to perform certain duties and functions related to market monitoring and facilitation.

The Director of Operations is directed to take all necessary steps to establish an Office of Competitive Market Oversight. The Office shall be permanently staffed with necessary technical and administrative support staff. Other Commission employees may be temporarily assigned to work for the OCMO on an as-needed basis. The Office shall be established and fully functional no later than Monday, January 5, 2009.

The OCMO will assume only advisory roles and informal mediation roles consistent with due process considerations that prohibit the co-mingling of advisory and prosecutory functions. One specific area of responsibility assigned to the OCMO is the mediation of disputes[7] involving the release, assignment or transfer of capacity on a natural gas distribution company's system[8].

B. PURCHASE OF RECEIVABLES PROGRAMS

Purchase of receivables was an issue that was considered by three of the subgroups as a means to increase supplier participation in the retail natural gas market. *SEARCH Report*, pp. 14-18. In a "Purchase of Receivables" (POR) program, the NGDC purchases a NGS's accounts receivable, most often at a discount. The discount may be attributable to uncollectible expense, *i.e.*, bad debt of the NGS's customers, and the NGDC's administrative costs for billing and collection. Purchase of receivables was also discussed as a means to satisfy security requirements for suppliers operating on certain NGDC systems. *SEARCH Report*, pp. 18, 20. Decreasing the security requirement for suppliers would remove a barrier to market entry for some suppliers and, thus, would increase supplier participation in the market.

The *SEARCH Report* recognizes that there are economic, legal and regulatory issues associated with mandating that NGDCs implement POR programs, and that establishing uniform rules to govern such programs would require further consideration

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[7] Requesting informal mediation by the OCMO will satisfy the due diligence requirement of the supplier meeting with the NGDC prior to filing a formal petition for Commission review of the company's capacity requirements. *See* 66 Pa. C.S. § 2204(d)(5)(ii) and § 2204(d)(6).

[8] Note that the OCMO's authority to mediate disputes between NGDCs and suppliers involving capacity is not exclusive. A supplier may choose to file a formal complaint, with notice to the OCMO, and may request mediation by the Office of Administrative Law Judge's Alternate Dispute Resolution Mediator.

of the various options to accomplish such programs in a manner that is fair to all stakeholders. *SEARCH Report*, pp. 16 -18. However, it is clear that POR programs may be voluntarily implemented by NGDCs, subject to Commission approval. Columbia Gas voluntarily implemented a POR program whereby it purchases accounts receivable at a discount from suppliers operating in its service territory. *See Pennsylvania Public Utility Commission et al. v. Columbia Gas of Pennsylvania, Inc.*, Order entered October 27, 2005 at Docket Nos. R-00049783; R-00049783C0001; R-00049783C0002; R-00049783C0003; R-00049783C0004; R-00049783C0005; R-00049783C0007 at pp. 148-156 (Issues Specific to Rider PPS -Discount Rate for Purchase of Choice Receivables).

Also, as part of its policy statement on *Default Service and Retail Electric Markets*, the Commission determined that the public interest would be served by further consideration of a purchase of EGS receivables program. *See* 52 Pa. Code § 69.1814 (relating to purchase of receivables); *Policy Statement on Default Service and Retail Electric Markets*, Order adopted May 10, 2007 at Docket No. M-00072009.

Disposition

The Commission agrees with the NGS comments that the use of POR programs can promote efficiencies, reduce costs to consumers and reduce barriers to market entry by alternative natural gas suppliers. The NGSs have long argued, and we agree, that the inclusion of billing and collection resources and costs in distribution rates provides an unfair subsidy in the provision of utility sales service and requires shopping customers to, in effect, pay twice for billing and collection. If this barrier to competition is reduced, the net result, for the benefit of consumers, is greater access to alternative supplier offers and competitive prices. At the same time, the Commission recognizes that any such program involves costs and risks that should be apportioned fairly between the NGDC and the NGS firms that participate in the program.

Moreover, this apportionment of costs and risks should also seek to eliminate redundancy in costs paid by NGS customers. For example, a NGDC's base rates contain costs for services related to bad debt and billing and collection. Because of this, a customer purchasing gas from a NGS is paying twice for bad debt and billing and collection service, once in NGDC base rates and again in NGS gas supply rates. The best way to prevent this situation, which will at the same time create a competitive marketplace, is by further unbundling the NGDC distribution rates and recognizing all of the costs related to gas supply service in the Price to Compare. For purposes of POR programs, the redundancy in cost situation affecting NGS customers may be prevented by requiring that the NGDC provide to the NGSs and its customers without additional charge those services that are already paid for in base rates, namely services related to bad debt and billing and collection.

In summary, while re-tooling the Price to Compare, in the long run, will assist in the establishment of a competitive retail market, we believe that properly designed purchase of receivables programs have a greater potential to immediately increase supplier participation in the market and, thus, would immediately increase "effective competition" in the retail market, which is the goal of this proceeding.

For this reason, by this order, we will encourage all NGDCs, who have not already done so, to file proposals to implement voluntary POR programs in their service territories. These proposals should be filed no later than December 31, 2008.

For those NGDCs that fail to file a proposed POR program by that date, the Commission will require each such NGDC to include, in its next base rate case or its next section 1307(f) gas cost proceeding, whichever comes first, fully allocated cost of service data by which the Commission can investigate the unbundling of natural gas procurement costs from base rates. In this fashion, the Commission will be able to investigate, evaluate and decide whether further unbundling of natural gas costs is warranted for that NGDC.

PHASE 2 – RULEMAKING PROCEEDINGS

As mentioned earlier in this order, Phase 2 will address those matters that require and are better handled by means of a rulemaking process before implementation. These rulemakings will address three (3) groups of issues: NGDC issues, NGS issues and business practices issues.

A. RULEMAKING INVOLVING NGDC ISSUES

The rulemaking regarding NGDC matters will address the following issues which relate most directly to the duties, rights and obligations of NGDCs: reformulation of the Price to Compare, Purchase of Receivables programs, mandatory capacity release and assignment and NGDC cost recovery of competition-related expenses and regulatory assessments.

1. Reformulation of the Price to Compare

The Price to Compare (PTC) is the listed NGDC price for natural gas supply that consumers use to compare offers from alternative NGSs when shopping in the retail marketplace. The Commission's October 2005 *Report to the General Assembly* discussed two possible barriers[9] to market entry and participation identified by suppliers that related to the NGDC's PTC for natural gas supply. *Report to the General Assembly*, pp. 53-61.

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[9] The *SEARCH Report* at pages 5-9 discusses these two subjects and the related issue of consumer education in regard to the pricing of natural gas supply at Section B (Price to Compare – Quarterly/Monthly Adjustments), Section C (Price to Compare - Consumer Education) and Section D (Gas Procurement Costs Contained within Base Rates).

The first barrier involved the costs that are incurred in the acquisition of natural gas supply, but that were excluded from the NGDC's PTC. Because the NGDC's PTC does not include all of the costs of gas supply acquisition, the PTC may present an artificially low price, making it difficult for the NGSs to compete against the NGDCs for customers. *Report to the General Assembly*, p. 60.

The second barrier identified by suppliers was the quarterly adjustment of the PTC pursuant to Section 1307(f). 66 Pa.C.S. § 1307(f). This adjustment creates a lag in recognizing increased gas costs so that consumers are confused as to the actual cost of the natural gas over time, and are lulled into thinking that the PTC is an annual fixed rate. In actuality, the NGDC's PTC represents a variable price with quarterly true-ups. *Report to the General Assembly*, p. 61.

The types of costs that should be recognized as gas procurement costs in a NGDC's PTC and the quarterly adjustment of the NGDC's PTC are complicated issues that were first considered in each company's restructuring filings. According to the *SEARCH Report*, the NGS community holds firm opinions that the current structure of annual rates based on least cost procurement strategies and reconciliation with interest shields the actual price to compare from consumers, thus making it difficult for NGSs to compete for customers based on price. *SEARCH Report*, p. 5.

The NGSs suggested that an option to address this problem would be directing 1307(f) NGDCs to file a fully allocated customer class cost of service study that removes rate base costs, and operation and maintenance expenses (related to natural gas procurement) from base rates, and creating a separate gas procurement surcharge to include these elements. In effect, through this process, the distribution rate would be unbundled. *SEARCH Report*, p. 8. The NGSs also suggest that the elimination of the reconcilable nature of the PTC would improve the competitive landscape by placing supplier of last resort (SOLR) service on the same platform as competitive alternatives.

SEARCH Report, p. 5. The NGSs also suggest that natural gas monthly prices be based on a monthly index such as the monthly New York Mercantile Exchange (NYMEX) or another financial index. *SEARCH Report*, pp. 3, 5 and 6.

The NGDCs do not oppose the development of a reasonable price to compare by shifting SOLR costs related to procurement from the distribution charge to gas costs so long as the costs can be tracked and recovered. The NGDCs state that some level of gas procurement costs currently in distribution rates may be necessary for NGDCs to maintain basic SOLR functions that benefit all customers, whether they are customers of NGS or NGDC commodity service. *SEARCH Report*, p. 9.

In contrast, consumers are understandably concerned about changes that might be made to the cost composition of the PTC, and the possible elimination of the 1307(f) reconciliation process. OCA stated that it must be made clear that only avoidable, or incremental procurement costs should be considered for inclusion in the PTC, and that including a wide range of costs in the PTC may simply artificially increase the cost to customers and not foster genuine competition. *SEARCH Report*, p. 8. In regard to the elimination of quarterly adjustments and reconciliation, OCA opposes frequent rate changes. *SEARCH Report*, p. 6.

Disposition

After review of the *SEARCH Report*, it is apparent that re-tooling of the PTC, in regard to its cost composition and automatic adjustment mechanism, is necessary to attract suppliers and increase effective competition in the retail natural gas supply market. Moving to a full market index rate or eliminating the reconciliation of gas cost rates for SOLR service would seem to be simple solutions that would immediately improve market opportunities for suppliers. However, implementing either could subject consumers to higher rates, and increased market volatility. The fairer method to establish a “market” PTC relies on cost allocation whereby costs properly attributable to the procurement of the commodity -- natural gas and other services related to gas supply service are included in the PTC.

To accomplish this, regulations must be promulgated that, *inter alia*, identify categories of costs that are properly allocable to the procurement of natural gas, and require that only those categories of costs be reflected in the market PTC.

Additionally, although most cost components of the market PTC may be assumed to be stable over a finite time period, costs for procuring natural gas may vary greatly over that same period depending on the weather, the season, and any other occurrence that might affect amount of available natural gas supply. To account for this variability, a reconciliation and adjustment mechanism should be established that will re-set the market PTC at regular intervals to account for changes in gas costs. Finally, the calculation of the market PTC should be standardized to eliminate inconsistency between NGDC territories that has been identified as a barrier to the full participation of suppliers in the state retail market.

Because our ultimate goal is to establish a truly competitive retail natural gas market in Pennsylvania, we will direct that a rulemaking be initiated to reformulate the PTC and provide for its adjustment to account for fluctuations in gas costs. We will direct that the Law Bureau draft a proposed rulemaking order that: (1) identifies costs that will be taken into account in calculating a market PTC; and (2) addresses the adjustment of the PTC due to the reconciliation of gas costs. The proposed rulemaking order will also establish parameters for purchase of receivable programs. Commission staff from the Bureau of Conservation, Economics and Energy Planning and the Bureau of Consumer Services is directed to provide technical assistance to the Law Bureau and the Bureau of Fixed Utility Services (FUS) in this rulemaking as may be needed. We further direct that the proposed rulemaking order be prepared to be acted upon no later than the end of the first quarter of 2009.

2. Purchase of Receivables

As explained earlier in this order, the Commission agrees with the NGS comments that the use of POR programs can promote efficiencies, reduce costs to consumers and reduce barriers to market entry by alternative natural gas suppliers. However, the Commission recognizes that any such program involves costs and risks that should be apportioned fairly between the NGDC and the NGS firms that participate in the program. The Commission also recognizes that Section 2205(c)(5) which prohibits mandatory pre-payment to entities that use NGDC billing services may preclude mandatory POR programs.

Disposition

In addition to encouraging NGDCs to propose voluntary POR programs, the Commission will also include, in its rulemaking related to NGDC issues, uniform rules and guidelines for POR programs. The Commission has and will continue to review voluntary POR programs on a case by case basis but, in the long run, the industry and the market will benefit from regulations that will provide clear rules and guidance for POR programs on a statewide basis. While there is room for flexibility in our approach to what constitutes a fair and reasonable POR program, NGS suppliers who operate regionally and nationwide should not need to deal with POR contract terms that vary substantially among different NGDCs in Pennsylvania.

Therefore, the rulemaking on NGDC Issues will address, among other issues, the appropriateness of a discount on accounts receivables and parameters for its calculation, the effect of a POR program on the NGDC's uncollectible expense and the use of a bad debt tracker. The overall goal is to establish reasonable and fair parameters for POR programs on a statewide basis. Again, we direct that a proposed rulemaking order be prepared so that the proceeding can be initiated no later than the end of the first quarter of 2009.

3. Mandatory Capacity Assignment

Section 2204(d)(1) of the Public Utility Code provides the NGDC with the option to release, assign or otherwise transfer capacity or Pennsylvania supply in whole or in part on a nondiscriminatory basis to suppliers or industrial customers on its system. 66 Pa.C.S. § 2204 (d)(1). The release, assignment or transfer of such capacity shall be on a nondiscriminatory basis and shall be at the applicable contract rate for such capacity. 66 Pa. C.S. § 2204(d)(1)&(3). Section 2204(d)(4) requires a licensed supplier to accept such release, assignment or transfer of capacity. 66 Pa.C.S. § 2204(d)(4). The issue is whether existing capacity assignment mandates should be modified. NGDCs assert that the mandatory assignment of capacity protects firm service for its SOLR customers while some NGSs see this requirement as a barrier to market entry. Other NGSs have concerns regarding the mechanisms for assigning capacity. This issue is discussed thoroughly in Section N of the *SEARCH Report* at pp. 31-34.

Disposition

The Commission understands the reason for mandatory capacity assignment as it ensures that SOLR service is continuous and reliable for the NGDC's customers. At the same time, the Commission can appreciate the suppliers' concerns about wanting the flexibility to purchase capacity on the pipeline as it suits the needs of their business operations. The Commission also recognizes the reality of the situation: (1) actual capacity release is a function of interstate pipeline tariffs, governed by the Federal Energy

Regulatory Commission; and (2) modifying the mandatory capacity assignment requirement requires legislative change.

However, because this issue has been identified as a barrier to competition by the suppliers, the ultimate solution may be to amend Section 2204(d)-(f) to lessen the control that a natural gas distribution company has over capacity on its system. Of course, such an amendment would need to be carefully crafted so as to ensure that system reliability is not put at risk for the sake of increased supplier participation. For this reason, we will direct the Director of Operations with the assistance of the Office of Legislative Affairs, the Office of Communications and other necessary legal and technical staff, to prepare a letter to the General Assembly recommending that a change be made in regard to Section 2204 and to prepare draft legislation amending this section.

The amendment of legislation is necessarily a protracted process, so it may not be an immediate solution. Therefore, in the interim, we will direct that the Rulemaking on NGDC Issues be drafted to include regulations to implement existing statutory requirements that the release, assignment or transfer of capacity by a NGDC shall be on a nondiscriminatory basis and shall be at the applicable contract rate for such capacity. 66 Pa. C.S. § 2204(d)(1)&(3). The proposed regulations will further define parameters for non-discriminatory assignment of capacity, the parameters for fair and reasonable contract rates, whether NGS firms can make alternative arrangements for needed capacity, and such other matters as are necessary to insure system reliability.

We also urge suppliers to use the existing remedies in Section 2204 to obtain some relief in regard to capacity management, and mandatory assignment of capacity. Section 2204(5)(i) of the *Act* permits a NGDC alone, or with one or more suppliers to voluntarily propose an alternative to capacity assignments, and Section 2205 (5) (ii) permits a supplier to petition the Commission for the authority to use alternate interstate storage or transportation capacity.

Section 2204 (f) requires that NGDCs provide for, and establish a working group of licensed natural gas suppliers having customers on the NGDC's system and representatives of residential, commercial and industrial customers (1) to meet on a scheduled basis and (2) to resolve operational and capacity issues related to customer choice. The Commission directs that each NGDC schedule a meeting for the first quarter in January 2009 for the purpose of discussing capacity in the context of system management. NGSs, regardless of whether currently active and serving customers on the company's system or not, shall be invited to the meeting.

Disputes involving capacity release that cannot be worked out in Section 2204(f) working groups[10] may be resolved informally by the Office of Competitive Market Oversight (OCMO). Suppliers who are not able to come to agreement regarding capacity release with a distribution company may file an informal complaint with the OCMO for possible mediation. Alternatively, the supplier, with notice to the OCMO, may file a formal complaint with the Commission and request mediation by the Alternate Dispute Resolution Division in the Office of Administrative Law Judge (OALJ)[11]. *See* the discussion of the creation of the Office of Competitive Market Oversight above at pp. 8-10. If an agreement cannot be reached, the supplier may file a formal petition with the Commission pursuant to review the capacity requirements pursuant to 66 Pa. C.S. § 2204(d)(5)(ii).

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[10] Section 2204(f) provides that the final determination of operational and reliability issues resides with the NGDC. 66 Pa.C.S § 2204(f).

[11] Requesting mediation from the OCMO or filing a formal complaint to be mediated by the OALJ is consistent with the statutory due diligence required of a supplier to meet and discuss possible alternatives with the distribution company prior to filing a Section 2204(d)(5)(ii) petition. *See* 66 Pa. C.S. § 2204(d)(5)(ii) and § 2204(d)(6).

4. NGDC Costs of Competition Related Activities

The physical venue for the retail natural gas market is the NGDC's transmission and distribution system as governed by the NGDC's operating rules and business practices and policies. Changes to the structure or operation of this retail market to lower or eliminate barriers to NGS entry and participation will necessarily result in costs to the NGDC.

The SEARCH group considered the issue of permitting NGDC recovery of costs related to the promotion of competition in the retail natural gas market. *See SEARCH Report* at Section E (relating to NGDC cost recovery), pp. 9-10. The *SEARCH Report* states that no legislative change is necessary to implement this cost recovery surcharge as it can be accomplished by a change to Commission regulations. *SEARCH Report*, p. 9.

Disposition

After review of the *SEARCH Report*, we find that the NGDCs should be able to recover *reasonable* costs that are *prudently* incurred in connection with the implementation of any changes designed to promote the development of effective competition in the retail market[12]. Also, a surcharge mechanism[13] that will ensure the recovery of these costs should have a positive effect on competition in that it would provide the funding needed by NGDCs to implement certain measures to increase competition in the natural gas supply market. *SEARCH Report*, p. 10. For these reasons, we believe that a surcharge with an automatic adjustment mechanism to recover these costs is in the public interest. Accordingly, we direct that issues related to NGDC recovery of costs attributable to the promotion of competition in the retail natural gas

[12] We note that these costs might also include those associated with increasing customer participation in the market such as modifications to NGDC billing systems or increased consumer education activities.
[13] In accordance with 66 Pa.C.S. § 1408 (relating to surcharges for uncollectible expenses prohibited), except for universal service and energy conservation costs, the surcharge may not be used to recover costs related to uncollectible expenses.

market, including the establishment of a customer surcharge, be addressed in the rulemaking on NGDC Issues.

5. Regulatory Assessments

A NGDC cost that may be amenable to collection through a surcharge mechanism is regulatory assessments that are collected to support the regulatory activities of the Commission and the statutory advocates -- the Office of Consumer Advocate and the Office of Small Business Advocate[14].

The current assessment process requires all regulatory costs allocated to the natural gas industry to be paid by the natural gas distribution companies. *See* 66 Pa.C.S. § 510 (relating to assessment for regulatory expenses upon public utilities); *Independent Oil and Gas Association of Pennsylvania v. PA PUC*, 804 A. 2d 693 (Pa. Cmwlth. 2000); appeal quashed 569 Pa. 508, 805 A. 2d 1212 (2000)(NGSs were not public utilities subject to regulatory assessments). The SEARCH participants considered an amendment to the Public Utility Code that would permit NGSs to be assessed for regulatory expenses based on commodity distribution throughput, but quickly rejected the idea as it could create another barrier to market entry and participation. *SEARCH Report*, p. 58. The discussion then turned to establishing an automatic assessment surcharge that would be used to recover assessments directly from consumers. This mechanism would allow NGDCs to recover these costs outside of a base rate case, similar to the way state taxes are collected from consumers. *SEARCH Report*, p. 58.

[14] A full discussion of the SEARCH Group's work on the subject may be found in the *SEARCH Report* in Section X (relating to NGDC assessment surcharge) at pp. 58-59.

Disposition

While this proposal will not directly increase competition in the retail natural gas market, establishment of a surcharge with an automatic adjustment clause is in the public interest as it will lower regulatory expenses and litigation costs related to the assessment process and subsequent cost recovery from customers. For this reason, we will direct that the proposed rulemaking on NGDC issues include consideration of an adjustable surcharge mechanism to permit NGDCs to collect regulatory expenses directly from its customers. The proposed rulemaking should also consider cost recovery relating to NGDC assessments in support of the activities of the Office of Consumer Advocate (71 P.S. § 309-4) and the Office of Small Business Advocate (73 P.S. § 399.46).

The Commission is very much aware of consumer concerns about a company's recovery of costs outside of a base rate case. However, the establishment of a surcharge with an automatic adjustment clause that allows for the timely recovery of regulatory assessments which will include costs of the Commission actions to promote and facilitate natural gas competition can be a fair and efficient means to recover costs from stakeholders.

B. RULEMAKING ON NGS ISSUES

Section 2208(c) of the Public Utility Code establishes the security requirement for the issuance and maintenance of a NGS license. 66 Pa.C.S. § 2208(c)(1). The criteria that are to be used by the NGDC to set the amount and form of the security were established in each company's restructuring proceeding. The level of security is based on a formula that takes into account the NGDC's exposure to costs. For the retail supply market, this formula involves the peak day demand estimate for capacity, number of days' potential exposure in a billing cycle, and commodity estimates for quantity and cost. Offsets to the amount of security that a NGS must provide may include calls on capacity, receivable purchases or receivable pledges. NGDC costs related to supplier default as set forth in Section 2207(k) of the Public Utility Code may also be taken into account when establishing the amount of security required. 66 Pa.C.S. § 2207(k). *SEARCH Report*, pp. 18-19.

If a NGDC and NGS cannot come to a mutual agreement, the level or form of security is determined by criteria approved by the Commission. *See* 66 Pa.C.S. § 2208(c)(1). These criteria were established in the Commission's NGS licensing regulations and are to be used to determine security levels and acceptable forms for the security when voluntary agreement is not reached. *See* 52 Pa. Code § 62.111. Section 62.111(c) permits the use of the irrevocable letters of credit, corporate parental or other third party guaranty, and real or personal property. Personal property would include the use of escrow account or the pledge or purchase of receivables. 52 Pa. Code § 62.111(c). *SEARCH Report*, pp. 18-19.

Also, an individual NGDC's security requirement, including the level of security, is subject to periodic review by the Commission. 66 Pa.C.S. §2208(c). *See also*, *UGI Utilities, Inc. – Gas Division v. PA PUC*, 878 A. 2d 186 (Pa. Cmwlth. Ct. 2005) appeal den. 586 Pa. 732; 890 A.2d 1062 (2005) (the Commission has discretion to approve criteria to be used to determine the financial security necessary based upon financial impact on the NGDC by a default by a NGS). Thus, a supplier is not without a remedy to address unreasonable security requirements of a NGDC on a case-by-case basis.

However, the *SEARCH Report*[15] states that suppliers observe that the use of security instruments is not uniform among the companies and contend that this variability is a barrier to market entry and multi-system participation. Suppliers also raised concerns

[15] This subject is fully discussed in the *SEARCH Report* in Section I (Creditworthiness/ Security) at pp. 18-21.

about the escalating cost of security to match the growth of their sales, and opined that there should be a limitation on the frequency of review of required security levels, with specific triggers for that review, such as a percentage change in pool size. *SEARCH Report*, p. 19.

Suppliers also view the NGDC's acceptance of only certain financial instruments as a barrier to market entry. Suppliers prefer to use corporate guarantees as the predominant practice. Further, to ensure fairness and remove a possible barrier for market entry, suppliers believe that specific criteria for acceptable financial instruments should be established in a regulation or order rather than permitting companies to set those through tariffs. *SEARCH Report*, p. 19.

Establishing standard language for the form of the financial instrument used for security and reasonable criteria for the amount of security should assist NGSs in obtaining security in an acceptable form and amount, while aiding the NGDC in collecting a claim against the security in the event of supplier default. North American Energy Standards Board (NAESB) forms and business practices could be reviewed for appropriateness to develop uniform language to address this issue. *SEARCH Report*, p. 21. Also, the use of a POR program should be examined as a way to reduce the level of required security, to lessen the need for frequent credit reviews and to ameliorate adjustments in security level that might normally be triggered by changes in a company's creditworthiness rating, which can occur for reasons unrelated to its immediate business interaction and relationships. *SEARCH Report*, p. 21.

Disposition

After reviewing the *SEARCH Report*, we believe that it is in the public interest for the Commission to initiate a rulemaking to address security requirements related to NGS licensing. The rulemaking will revise Commission regulations at Section 62.111

(relating to bonds or other security), and other related regulations in regard to the required level of security and the acceptable forms of security permitted to satisfy the statutory security requirement for licensing at 66 Pa.C.S. § 2208(c)(i)(relating to requirements for natural gas suppliers; financial fitness). The goal of this rulemaking will be to update the Commission's existing regulations regarding security requirements to better balance the ability of NGS firms to provide adequate security with the NGDC's risk of a supplier default.

The use of NGS accounts receivables in POR programs will be considered in regard to creditworthiness standards and as fulfillment of some part or all of security requirements. The rulemaking will also examine the adoption of standard language for the form of the financial instrument used for security and reasonable criteria for the amount of security. Finally, adoption of NAESB forms and business practices will be considered. We will direct that the Law Bureau and FUS to prepare a proposed rulemaking order on these issues to be acted upon at the December 4, 2008 Public Meeting.

C. RULEMAKING ON BUSINESS PRACTICE ISSUES

The physical venue for the retail natural gas market is the NGDC's transmission and distribution system as governed by the NGDC's operating rules, and business practices and policies. In the Commission's investigation into competition in the retail natural gas market, the suppliers identified certain of these NGDC operating rules and business practices as barriers to market entry and participation. *Report to the General Assembly*, pp. 50-52.

SEARCH participants examined the following NGDC operating rules, practices and policies related to the management of natural gas on the system: nomination and delivery requirements; tolerance bands related to balancing; and cash out/penalties. The

SEARCH group also examined the following subjects that were identified as barriers to full market participation by suppliers:

- the lack of uniformity in the operating rules between NGDC systems.
- the lack of uniformity in NGDC supplier tariffs.
- the lack of uniformity regarding electronic data transfer protocols.
- the lack of uniformity in regard to the existence and implementation of electronic bulletin boards.
- the lack of uniformity regarding creditworthiness and security.

A short summary of the group's discussions and possible solutions presented in the *SEARCH Report* for these identified barriers is presented below.

1. Standardization of NGDC System Operating Rules[16]

Differences among NGDC systems in regard to their organization and operation have been identified as a barrier to supplier entry and full participation in Pennsylvania's retail natural gas market. Interactions related to system operations (or asset management of natural gas supply) involve the exchange of information between NGSs and NGDCs. These interactions entail the day-to-day activities necessary to assure reliable delivery of natural gas to customers on the system.

Requiring all NGDCs to migrate to a preferred model for managing system assets would require comprehensive legislative changes and subsequent Commission proceedings to ensure due process related to property rights. However, certain business practices governing interactions between the suppliers and the NGDC can be tailored to operate within the preferred model. *SEARCH Report*, p. 13. This preferred model would streamline and/or standardize certain interactions between the NGSs and NGDCs involving gas supply management on the NGDC system. These best business practices

[16] This subject is fully discussed in the *SEARCH Report* in Section G (Standardization of NGDC System Operations) at pp. 11-14.

could be defined and memorialized in a generic supplier's tariff or promulgated in Commission regulations. *SEARCH Report*, p. 13.

A subgroup of NGDCs and NGSs (including pipeline operators) considered the possibility of conforming NGDC-NGS business practices to those recommended by the NAESB. The NAESB subgroup reviewed each set of standards/business practices of each of these categories to determine if the standard or practice is already addressed by Pennsylvania rules, regulations and/or statute, is appropriate for consideration as a Pennsylvania business practice, may or may not be appropriate for Pennsylvania, or is not applicable. The members of this subgroup have differing levels of agreement as to whether certain standards or practices should be considered. This issue would require more exploration if it is to be pursued. *SEARCH Report,* pp. 13-14.

Standardizing some NGDC business practices through the adoption of NAESB practices could be implemented by a Commission rulemaking, or through the incorporation of NAESB practices by reference in a generic suppliers' tariff. Such changes to NGDC business practices would require less time to implement and would incur lower costs because of previous work on NAESB that has already been completed. *SEARCH Report,* p. 14.

2. NGDC Operating Rules

a. Nomination Rules and Delivery Requirements[17]

The type of relationship established between the NGDC and the NGS dictates the frequency of daily interactions involving information exchange on nominations and deliveries. In the partnership type of relationship, where a NGS is expected to manage supply, capacity and storage assets, information exchange is expected on a more routine

[17] This subject is fully discussed in the *SEARCH Report* in Section J (Nomination and Delivery Requirements) at pp. 21-25.

and regular basis. In the situations where the NGDC acts as the parent and is expected to manage the array of assets, there is less required communication and hence, less interaction. *SEARCH Report*, p. 21.

Under a partner relationship, it is essential that the NGDC and NGS communicate in advance of each gas day cycle for nomination. The NGDC provides the NGS with outlooks for its customer pool, based upon weather forecasts and recent patterns of consumption activity. The NGS then utilizes that information together with its intelligence to formulate its gas day nomination. The timing for the main gas day nomination is different for each NGDC. *SEARCH Report*, p. 22.

Under wholesale rules established by North American Energy Standards Board (NAESB), four nomination cycles can be used to communicate information on gas required movement. In most cases, NGSs are only permitted to use the main cycle and can not make intraday nominations. Because these nomination periods could be used to adjust flows, the NGS is exposed to a greater risk of balancing penalty due to the mismatch of nominations and deliveries. At this time, no NGDC provides a NGS with the opportunity to use all of its nomination cycles. *SEARCH Report*, p. 22.

The *SEARCH Report* concludes that the elimination of inflexible or unreasonable nomination rules and delivery requirements[18] that are not based on reliability concerns or physical NGDC system constraints would encourage supplier participation. The standardization of the rules for nomination and delivery requirements would lower operational costs for suppliers and facilitate supplier participation in multiple NGDC markets. *SEARCH Report*, p. 24.

[18] For a more thorough explanation of how nomination rules and delivery requirements relate to tolerance bands and cash out/ penalties, see *SEARCH Report* at pp. 21-23.

To implement changes to nomination rules and delivery requirements and customer pooling or aggregation requirements, individual NGDC supplier coordination tariffs would need to be reviewed and amended. To establish uniform rules governing such matters, a Commission investigation could be undertaken. The uniform rules could be issued as a model supplier coordination tariff or promulgated in Commission regulations. *SEARCH Report*, p. 24.

b. Tolerance Bands[19]

Tolerance bands represent an operational flexibility accorded to transactions to accommodate the timeframes for actual movement of gas on a system or pipeline and the inherent measurement variations and recording lags associated with that movement. Simply put, a tolerance band is a range of acceptable values for the measured difference between the gas volume that is nominated to be delivered in a certain time frame on a NGDC's system and the gas volume that is actually delivered during that time frame by a NGS. Current Pennsylvania practice regarding tolerance bands, for both monthly and daily balancing programs run the spectrum from being based on tolerances of individual customers to being based on customer pools with bands of 2.5 percent up to 5 percent and 10 percent. *SEARCH Report*, p. 25.

In regard to tolerance bands, the *SEARCH Report* states that the adoption of wider tolerance bandwidths, along with other rules affecting system flow could lessen the possibility that NGSs operating on the system will incur penalties for imbalances. Broadening the tolerance bands to a reasonable width affords the NGS more flexibility in providing supply volume and in making business decisions in regard to the expansion of its sales and activities. The actual impact on effective competition will depend on the adoption of the proper system operations model and tariff design. *SEARCH Report*, pp. 27-28.

[19] This subject is fully discussed in the *SEARCH Report* in Section K (Tolerance Bands) at pp. 25-28.

c. Cash Out/Penalties[20]

Cash out is a term applicable to a settlement payment for gas purchased or sold between the NGDC and NGS in order to balance system supply. Penalties act as a deterrent to the NGS to manage its gas supply on the NGDC system so as not to fall outside the tolerance bands established to maintain system integrity. *SEARCH Report*, p. 28. The penalties are to compensate SOLR customers for use of their gas supply assets to balance the system. *SEARCH Report*, p. 28. According to the *SEARCH Report*, the goal of suppliers in proposing measures to reform cash out rules in NGDC supplier coordination tariffs is to decrease operational costs. Reforming cash out rules and other rules related to the management of supplier gas on the NGDC systems should increase supplier participation in the retail natural gas market. *SEARCH Report*, p. 29. Rules regarding cash out and penalties appearing in a NGDC's supplier coordination tariffs may be reviewed and amended as may be necessary by the Commission, after notice and opportunity to be heard. *SEARCH Report*, p. 29.

3. Standardization of Electronic Bulletin Boards[21]

Electronic Bulletin Boards (EBBs) are maintained by NGDCs and are accessed via a secure network/Internet connection by NGSs to post nominations and schedule deliveries of natural gas on the NGDC's system. Most NGDCs use a form of EBB, but there is little standardization of the format and operability. *SEARCH Report*, p. 29.

Suppliers believe the use of EBBs facilitate communications and enhance interactions between NGDCs and suppliers in regard to the movement of natural gas and delivery to customers which would allow for growth of supplier market share. Standardization of EBB format, content, functionality and use may also reduce errors.

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[20] This subject is fully discussed in the *SEARCH Report* in Section L (Cash Out/Penalties) at pp. 28-29.
[21] This subject is fully discussed in the *SEARCH Report* in Section M (Electronic Bulletin Boards) at pp. 29-31.

SEARCH Report, p. 31. Although EBBs may prove to be cost-effective in reducing errors, maintaining EBBs may be expensive. NGDCs would seek to recover costs through distribution rates. Also, the time lag in posting current information can be excessive so that the EBB can itself become a barrier to timely implementation of NGS-NGDC interactions. *SEARCH Report*, p. 31.

The suppliers offered a number of ideas related to best practices and standard content for EBBs. *SEARCH Report*, pp. 29-30. No change in legislation is necessary; rather, the requirement could be implemented as the result of a Commission investigation or through the rulemaking process. Cost issues could also be addressed in the same proceeding. *SEARCH Report*, pp. 30-31.

Disposition

The Commission directs that the Law Bureau and the FUS initiate a rulemaking on supplier coordination tariffs. The purpose of the rulemaking will be to revise and, when feasible, standardize supplier coordination tariffs and NGDC system operating rules, business practices, requirements, penalties and procedures to remove or reduce barriers to supplier participation in the retail natural gas market. Major issues that should be addressed include:

- The elimination or revision of inflexible or unreasonable nomination rules and delivery requirements[22].
- The adoption of wider tolerance bandwidths, where justified, and the elimination or revision of other rules affecting system flow that do not negatively impact system reliability.
- The revision of unreasonable cash out rules and penalties.
- The adoption of best business practices related to information exchange and data transfer, including the possible standardization of NGDC business practices by the adoption of certain NAESB practices.

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[22] Data related to imbalance penalties, cash out penalties and system gaming that was filed by the PGW and Hess at this investigation docket in compliance with the Commission's order in *PA PUC, et al. v. Philadelphia Gas Works*, order entered September 28, 2007 at Docket No. R-00061931, pp. 126-127, shall be considered in this rulemaking.

The use and standardization of Electronic Bulletin Boards will also be addressed. The proposed rulemaking order should be completed so that it may be acted upon by the Commission no later than end of the first quarter of 2009.

FUTURE EVALUATION OF EFFECTIVE COMPETITION

The SEARCH Group studied two proposals that would allow for future evaluation and monitoring of competition in the retail natural gas market. The first proposal involves the establishment of a future milestone date where the state of competition in retail natural gas supply services market could be evaluated. The first evaluation was proposed to commence two to five years after implementation of the key measures that result from this collaborative. Alternatively, the Commission could direct that the follow-up evaluation be scheduled for a set number of years after its initial action resulting from this process. *SEARCH Report*, p. 59. The milestone review may be initiated by Commission order. *SEARCH Report*, p. 60.

This evaluation would be a more formal review and would supplement any day-to-day monitoring of competition by Commission staff. *SEARCH Report*, p. 59. The criteria for the evaluation would include the same criteria that the Commission considered in its October 2005 Report to the General Assembly: participation in the market by many buyers and sellers, the lack of substantial barriers to market entry for suppliers, the lack of substantial barriers that would discourage customer participation and the presence of sellers offering buyers a variety of products. *SEARCH Report*, p. 59. Not all issues that are being studied in this review need to be included in the evaluation. The scope of the evaluation should be decided after stakeholders gain experience with changes that were made as a result of this review. *SEARCH Report*, pp. 59-60.

The second proposal calls for the appointment of members of Commission staff to monitor competition and to address daily or on-going issues that arise affecting the above-mentioned criteria. *SEARCH Report*, p. 60. The appointment of these staff members should be made shortly after the conclusion of this review. Input from these staff members would be considered during the subsequent milestone evaluation. *SEARCH Report*, p. 60. *See* Section Y of the *SEARCH Report* at pp. 59-61 for further discussion of these proposals.

Disposition

The *SEARCH Report* rates the establishment of a future milestone review as having a moderate effect on the development of competition since it would give marketers a level of comfort that, if the changes made to the market as a result of this review are now insufficient, a forum will be provided for implementing additional measures as may be necessary. *SEARCH Report*, p. 60. We note that this retrospective review process should give the other stakeholders – customers, NGDCs and pipelines – the same level of comfort. Therefore, we will direct that such a formal review be scheduled five years from the entry date of this order.

At pages 9-10 of this order, *supra,* we directed that the Director of Operations take all necessary steps to create an in-house Office of Competitive Market Oversight, whose duties will include, *inter alia*, market monitoring and informal dispute resolution between suppliers and distribution companies. This Office will also be charged with conducting the future milestone review.

CONCLUSION

The purpose for convening the natural gas stakeholders was to explore avenues to increase competition in the retail natural gas supply market. The work of the group, as documented in the *SEARCH Report*, not only has provided us with possible solutions to increase supplier participation in the retail market, but also has demonstrated the commitment of all stakeholders to this goal.

We have developed an action plan that incorporates many of the solutions that were identified in the *SEARCH Report* that have the greatest potential to eliminate or reduce market barriers for suppliers. With this final order, we have set forth this plan and have set it in motion. We thank the stakeholders for their past assistance and for their continued participation as we move forward with this plan to improve market conditions for the benefit of all stakeholders consistent with the pro-competition policy goals embodied in the *Natural Gas Choice and Competition Act*; **THEREFORE,**

IT IS ORDERED:

1. That the *SEARCH Report* is adopted and issued for public release. The Report may be accessed at the PUC web page for the Natural Gas Stakeholders' Working Group: http://www.puc.state.pa.us/naturalgas/naturalgas_stakeholders_wg.aspx.

2. That the Law Bureau and the Bureau of Fixed Utility Services, with the assistance of other technical staff as may be required, prepare a proposed rulemaking order on **NGDC Issues** as set forth in this order. The proposed rulemaking order shall be prepared so that it can to be acted upon no later than the end of the first quarter of 2009.

3. That the Law Bureau and the Bureau of Fixed Utility Services, with the assistance of other technical staff as may be required, prepare a proposed rulemaking order on **NGS Issues** related to creditworthiness standards and security issues as set forth

in this order. The proposed rulemaking order shall be prepared so that it can to be acted upon at the December 4, 2008 Public Meeting.

4. That the Law Bureau and the Bureau of Fixed Utility Services, with the assistance of other technical staff as may be required, prepare a proposed rulemaking order on issues related to **Business Practices** as set forth in this order. The proposed rulemaking order shall be prepared so that it can to be acted upon no later than the end of the first quarter of 2009.

5. That the Director of Operations is directed to take all necessary steps to establish an Office of Competitive Market Oversight. The Office shall be established and fully functional no later than Monday, January 5, 2009.

6. That the Director of Operations prepare, in consultation with the Law Bureau, a letter to the General Assembly requesting that the amendments to the Public Utility Code as set forth in this order be enacted.

7. That all jurisdictional natural gas distribution companies subject to the requirements of the *Natural Gas Choice and Competition Act* are directed to schedule a Section 2204(f) working group meeting for the first quarter in January 2009 for the purpose of discussing capacity in the context of system management.

8. That all jurisdictional natural gas distribution companies subject to the requirements of the *Natural Gas Choice and Competition Act*, who have not already done so, are encouraged to file proposals to implement a voluntary Purchase of Receivables programs no later than December 31, 2008. An original and 15 copies of the proposal shall be filed with the Secretary, Pennsylvania Public Utility Commission, P.O. Box 3265, Harrisburg, PA 17105-3265.

9. That a jurisdictional natural gas distribution company subject to the requirements of the *Natural Gas Choice and Competition Act* that does not offer or has not filed a proposed purchase of receivables program by December 31, 2008, shall include, in its next base rate case or its next section 1307(f) gas cost proceeding, whichever comes first, a fully allocated cost of service study by which the Commission can investigate the unbundling of natural gas procurement costs from base rates.

10. That the Secretary shall serve a copy of this order upon all jurisdictional natural gas distribution companies, licensed natural gas suppliers, the Energy Association of Pennsylvania, the Office of the Consumer Advocate, the Office of Small Business Advocate, the Office of Trial Staff and all other parties filing comments at Docket No. I-00040103.

11. That this docket be closed.

BY THE COMMISSION,

James J. McNulty
Secretary

(SEAL)

ORDER ADOPTED: September 11, 2008

ORDER ENTERED: September 11, 2008

COMMONWEALTH OF PENNSYLVANIA
PUBLIC UTILITY COMMISSION

Investigation into the Natural Gas Supply Market
Docket No. I-00040103F0002

Report on the Stakeholders' Working Group

Stakeholders Exploring Avenues
for Removing Competition Hurdles

("SEARCH")

September 2008

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Investigation into the Natural Gas Supply Market
Docket No. I-00040103

Introduction

The Natural Gas Choice and Competition Act, 66 Pa. C. S. §§ 2201-2212 (Act), which gave all retail customers the ability to choose their natural gas supplier, required the Commission to conduct a review five years after the law became effective to determine "whether effective competition for natural gas supply services exists on the natural gas distribution companies' systems in this Commonwealth." 66 Pa.C.S. § 2204(g).

The Commission opened its investigation in May 2004, and asked natural gas distribution companies (NGDCs), natural gas suppliers (NGSs) and interested parties to comment on the level of competition in the market. On September 30, 2004, the PUC held an *en banc* hearing for further exploration. After an extensive review of the investigation's evidence, the Commission determined that there is not effective competition in the retail natural gas supply market at this time.

The Commission submitted its report to the General Assembly on competition in Pennsylvania's retail natural gas supply market with its conclusions on October 6, 2005. The Commission determined that "effective competition" does not exist in the retail natural gas supply market statewide, and that it should reconvene the stakeholders in the natural gas industry to examine avenues, including legislative, to increase competition in Pennsylvania's retail natural gas supply service market. *Investigation into the Natural Gas Supply Market: Investigatory Order and Report to the General Assembly*, Docket No. I-00040103, order entered October 6, 2005 at 4.

As directed by the Act, the *Report to the General Assembly on Competition in Pennsylvania's Retail Natural Gas Supply Market* was issued to the Governor, the General Assembly, the Office of Consumer Advocate (OCA), the Office of Small Business Advocate (OSBA), the Energy Association of Pennsylvania (EAPA), all jurisdictional natural gas companies, licensed natural gas suppliers and other participants to the investigation proceeding.

In its investigation, the Commission found that:

The record demonstrated a lack of participation by natural gas suppliers and buyers in the retail natural gas supply services market on a statewide basis;

According to suppliers, substantial barriers to entry in the retail natural gas market exist because of differing security requirements among natural gas distribution companies (NGDCs);

According to suppliers, substantial barriers to entry and continued participation by natural gas suppliers (NGSs) exist as the result of the omission of procurement, administrative and other costs from the NGDC's price to compare;

According to suppliers, substantial barriers to supplier participation exist because of penalties placed on suppliers that vary among NGDC systems which are not cost-based and

The marketplace lacks accurate and timely price signals. As a result, the market cost of natural gas supply service offered by natural NGDCs is not communicated immediately to customers.

Since the investigative report concluded that natural gas competition does not exist at this time, the Commission reconvened a stakeholder group in the natural gas industry to explore avenues, including legislative, for encouraging increased participation in Pennsylvania's retail natural gas supply service market. Referred to as Stakeholders Exploring Avenues for Removing Competition Hurdles (SEARCH), the collaborative consisted of representatives of consumers, NGDCs, NGSs (sometimes referred to as suppliers or marketers), wholesale suppliers, and pipelines. SEARCH examined the barriers and identified changes to the market structure and operations that would facilitate the development of competition in the retail supply market in Pennsylvania.

The initial meeting of SEARCH was held March 30, 2006. Four subgroups were established to study related issues.

Inter-Company Activity;
Customer Interface;
Cost of Service; and
Competition Monitoring

An additional subgroup was established after the collaborative effort began. It looked at issues surrounding the possible abandonment of the merchant function by gas utilities and the development of a supplier of last resort model. Also, the group as a whole discussed various overlapping issues.

The subgroups and the entire working group met a number of times at the Commission's offices in Harrisburg, as well as via conference calls. Draft documents that became the basis of this report were exchanged at these meetings.

Discussion of Possible Solutions

This report discusses possible solutions to those barriers identified in the October 6, 2005, *Report to the General Assembly*. It does not make recommendations as to particular solutions to those obstacles. That will come through a policy statement or other action to be formulated and adopted by the Commission in the near future. Therefore, this report should not be interpreted as an endorsement of a particular course of action by the Commission itself, its staff or the stakeholders.

For each item discussed in this report, there is a description of the issue, a summary of the participants' views, an explanation of what would be needed to implement the solution, an evaluation of the impact of that measure on the development of effective competition and a discussion of the disadvantages and costs of implementation. While the report does not fully address all aspects of an issue that were raised during the discussions, it is an attempt to fairly characterize the various barriers and possible solutions that were identified.

A. Natural Gas Distribution Companies Exiting the Merchant Function

1. The Issue – Based on assertions that competition will not thrive if NGDCs serve as merchants, a small group of participants held in-depth discussions concerning supplier of last resort (SOLR) models. During the course of the discussions, two principal issues arose. First, the group discussed whether a NGDC procuring supply for its SOLR obligation through a least cost procurement strategy constitutes a barrier to a fully competitive supply market. Second, the group considered whether the SOLR model being used by the NGDC should continue to include reconciliation for over or under-collection. Also, several participants raised the possibility of a SOLR model in which the provider was an approved NGS (which could include a NGS affiliated with a NGDC).

Representatives from the NGS community suggested a market-indexed SOLR plan. Under that plan, a gas cost rate would be established using a market index formula. The index based formula rate could be set as a:

Yearly fixed rate with a fixed delivery adder;

Three-month price with the fixed delivery adder; or

Multi-year fixed price (two or three years) with the fixed delivery adder.

The market index rate and adder would be non-reconcilable, and the full rate and its derivation would be published in advance of the effective date to permit NGSs to market their services knowing the SOLR rate. A second option for the market index approach is a three-month SOLR obligation, which is auctioned off to willing NGSs who would agree to serve customers on the basis of an established market index gas cost rate plus delivery adder. In the second option, the actual winners would be based on the lowest delivery adder.

The group also discussed the current experimental SOLR program in Dominion East Ohio. That program features monthly prices based on the monthly New York Mercantile Exchange (NYMEX).

There was some discussion of removing the social obligations from the SOLR model (whether held by the NGDC or another entity). The possibility of moving those obligations to a governmental entity with funding generated by a pipes charge on throughput to residential customers was explored.

Finally, the group discussed the potential for NGDCs to exit the merchant function, in which case SOLR service would be provided by NGSs, including NGS affiliates of NGDCs.

2. Positions of the Participants - Support for some form of market-index SOLR without reconciliation came from representatives in the NGS community. These participants noted that reliability would be maintained because the NGDC remains in control of distribution and system operations. The non-reconcilable price gives customers a transparent price to compare and promotes competitive alternatives.

NGS representatives pointed out that when Section 1307(f) of the Public Utility Code, 66 Pa.C.S. § 1307(f), was written and a least cost procurement policy became the standard, there was no wholesale gas market. NGDCs were buying gas combined with transportation under long-term contracts. The current market structure, which has significant volatility, has numerous commodity purchase options and requires price risk mitigation strategies, is far different than the limited bilateral market that existed when Section 1307(f) went into effect.

Consumer representatives and NGDCs were opposed to the short term or indexed market models and to the suggestion that the NGDCs should exit the merchant function. Consumer representatives were concerned that changes to the current system of least cost procurement would necessarily either raise rates, increase consumer exposure to market volatility or both. NGDCs expressed concerns that the non-reconcilable nature of the proposed model placed extraordinary risks on the NGDC as the SOLR provider. It was suggested that an 8 percent change in the market price of gas could either eliminate or double a NGDC's earnings in a year. Both consumer representatives and NGDCs believed that the Dominion East Ohio SOLR pilot was in the early stages of operation, and was not a useful model to examine at this time. Consumer representatives also suggested that the Dominion East Ohio model exposed SOLR consumers to volatility on a monthly basis, which was particularly harsh for low-income, moderate-income and fixed-income households.

While the NGS community maintains an interest in modifying the current Section 1307(f) process, particularly with regard to reconciliation, consumer representatives and NGDCs support retention of that model. One modification that NGSs suggested was that, if reconciliation is maintained, there should be no interest collected on under-collections and no interest paid on over-collections. NGSs believe that this may provide an incentive to NGDCs to more accurately predict gas costs and mitigate some of the negative impacts reconciliation has on competitive pricing by NGSs.

Some participants thought that the concept of NGDCs exiting the merchant function needed to be examined, but other participants disagreed with the entire concept. All participants agreed that the market is simply too immature to move to that construct at this time. It was generally agreed that the best approach was to provide market improvements that would eliminate or reduce other barriers to entry. One participant suggested that the best approach was to improve the market to such an extent that NGDCs would voluntarily exit the market function as part of their own business plan.

Although some participants suggested that removal of social obligations from the SOLR would create a more favorable environment for the creation of non-NGDC SOLR provider, this concept did not receive general support. In particular, consumer representatives opposed the concept, consistent with their view that the NGDC must retain the SOLR function for the foreseeable future.

3. Requisites for Implementation - If the Commission were to determine that a market-indexed, non-reconcilable approach for SOLR models was in the public interest, Section 1307(f) would need to be examined and modified. That examination would necessarily include a review of what a least cost procurement policy means in today's market. It was suggested that if a NGDC voluntarily adopted a market indexed SOLR model with Commission approval, there would be no need for legislative change. However, it appears that absent consensus by all participants, Section 1307(f) would be a barrier to a non-reconcilable SOLR rate. In addition, Sections 1317 and 1318, 66 Pa.C.S. §§ 1317 and 1318, connect a least cost procurement strategy to the actual rate to be charged. Accordingly, if a market-indexed approach were to be adopted wherein gas cost rates are set based on some index (NYMEX prices being the one most often referenced), there is a question of whether the market index would actually be tied to a least cost procurement strategy as mandated in Sections 1307(f), 1317 and 1318. Finally, the Commission's regulations at 52 Pa. Code §§ 53.61 – 53.69 would have to be reviewed to determine whether changes would be required.

4. Impact on Effective Competition - The NGS community holds firm opinions that the current structure of annual rates based on least cost procurement strategies and reconciliation with interest shields the actual price to compare from consumers. NGSs argue that this model prevents NGSs from competing for market share based on price. NGSs assert that regardless of whether a NGDC intentionally undercuts pricing in a Section 1307(f) proceeding or not, the effect is that the NGDC is guaranteed recovery of any losses (with interest) while a NGS is forced to compete at the stated price with no chance to recover any losses. NGSs argue that elimination of at least the reconcilable nature of the NGDC rate would provide for a more level playing field and, presumably, improve the competitive landscape. NGSs also argue that moving to a full market based approach would further improve the competitive landscape by placing SOLR service on the same platform as competitive alternatives.

5. Disadvantages and Costs – Consumer representatives, NGDCs and the EAPA hold equally firm opinions that either shifting to a full market indexed rate or elimination of the reconcilable nature of gas cost rates would merely serve to increase rates for consumers for no reason other than to improve market opportunities for suppliers. According to these participants, the Section 1307(f) methodology with reconciliation produces the lowest possible prices for consumers. It is up to the suppliers to beat that price through better procurement strategies, product differentials or other marketing strategies. These participants argue that if the current Section 1307(f) procedure produces the best prices, there is no reason to change. In addition, consumer representatives advanced substantial concerns that several market-indexed models subject consumers to significant market volatility which adds to the downsides of these models.

B. Price to Compare – Quarterly/Monthly Adjustments

1. The Issue – Marketers assert that the quarterly adjustment of the "price to compare" makes it difficult to compete since a NGDC's price often changes quarterly and sometimes includes significant adjustments. They claim that this approach produces a natural incentive for the NGDCs to under project natural gas costs and place an artificially low annual rate into effect, which they will then reconcile through an upward adjustment in the first quarterly filing. The NGDCs are not harmed since they are permitted to claim interest on under-recoveries. This practice is viewed by marketers as a barrier to competition because there is a three-month window of opportunity for the NGDCs to lock customers into one-year contracts.

The issue involving the price to compare and the quarterly filings is complicated and has evolved over the years through litigation and settlements of the Section 1307(f) filings. In addition, the Commission has not directed a particular formula as to the components of the quarterly filings and none of the NGDCs calculate the quarterly filings in an exact format. Based upon the C-factor (gas cost projections) and E-factor (reconciliation of projected gas costs to actual gas costs), establishing a projected annual price to compare for the NGDCs is difficult at best.

Several possible solutions were discussed. They include: 1) establishing a particular formula for the quarterly filing so that it is more consistent and predictable; 2) eliminating the quarterly adjustment, except when the rate differs by more than 2 percent, with consumers who prefer an adjustable rate seeking that from the market; 3) eliminating interest on under-recoveries, which would remove one of the incentives for NGDCs to under project gas costs in the annual filing; and 4) using a monthly variable price, which would be similar to the NYMEX settlement price that has been adopted in Ohio and minimizes the need for reconciliation.

2. The Position of the Participants - Marketers support a change that eliminates quarterly adjustments. Their preference is for the NGDC price to reflect, to the extent possible, a timely, market based price, such as the NYMEX settlement price.

OCA opposes frequent rate changes. It further states that programs should be tailored to individual companies.

EAPA said NGDC commodity prices should not be made higher simply to promote competition. Attempts to manipulate NGDC gas cost pricing to facilitate a price to compare amount to an exercise in futility and may actually result in promoting customer migration back to NGDC commodity service from NGSs. Regarding interest on under-collections, one NGDC asserted that borrowing short-term debt to fund undercollections is more costly. Moreover, the NGDCs' under-recovery of current gas costs benefits its customers with lower current gas bills. The elimination of quarterly adjustments to the NGDCs' gas costs would be a financial disaster and possibly bankrupt many NGDCs.

3. Requisites for Implementation - Any of these solutions would require statutory changes and revisions to Commission regulations.

4. Impact on Effective Competition - If the price to compare is a monthly price such as the NYMEX settlement price or if the quarterly adjustment process is eliminated, consumers would receive more accurate price signals and more may opt to participate in the competitive market.

5. Disadvantages and Costs. With a monthly market price, consumers' rates would be changed frequently, and price spikes in the market would be felt more immediately and significantly than when they are spread over a longer period of time. If the quarterly adjustment process is eliminated, consumers would sometimes pay more than the actual cost of gas.

C. Price to Compare - Consumer Education

1. The Issue - NGSs express several concerns about the "price to compare" from a consumer education standpoint. If consumers do not understand what the price to compare represents, they are unable to make informed decisions about whether the offers presented by NGSs are competitive. For instance, when the price to compare is provided to the customer, it is not accompanied by any explanation. Even the term itself has been criticized as misleading and as possibly too "utility-oriented" by always inviting comparison to the utility.

NGSs further note that timeliness is a concern since the price to which the consumer is comparing the NGS offer is not necessarily a current price, but rather one that will change at least quarterly. Consumers may think that what is being compared is a utility's "fixed" price with a suppliers' variable rate, when in fact both rates are variable. Some have suggested changing the label to something like "utility current offer" or "utility current natural gas supply offer" as a more accurate reflection of pricing realities.

Some stakeholders, particularly NGSs, propose the use of explanatory labels to accompany the "price to compare" that would assist consumers in fully understanding what it is and how to use it. It could be qualified by noting that that it is not a fixed price, or by noting the effective dates of the price or perhaps it should just be noted that it is subject to change.

2. The Position of the Participants – NGSs believe that consumers are confused by rates and pricing, and that they will not shop. Therefore, they view these issues as presenting serious barriers to competition.

NGDCs in general do not object to the idea of modifying the term to "current price to compare" or "current quarterly price to compare." They state, however, that they do provide explanations of the price-to-compare and the gas cost rate along with other terms on the back of bills and in consumer education brochures. In addition, utility call center staff can discuss and explain these things to consumers. NGDCs question how practical the suggestions are about including more explanation about the price to compare when it is furnished, especially from the standpoint of how much information will fit onto a bill.

NGDCs further insist that any consumer education programs that are mandated should be considered and implemented on a utility-specific basis as opposed to a general statewide requirement. Consumer representatives believe that a true benefit has to be shown before customers are asked to shoulder any additional consumer education costs. Commercial and industrial consumer representatives likewise insist that since the consumer education efforts would not be aimed at or benefit commercial and industrial consumers, the costs of such should not be allocated to these consumers.

3. Requisites for Implementation. Section 2206(d) of the Public Utility Code already provides that NGDCs implement consumer-education programs that provide customers with information necessary to help them make appropriate decisions about their retail natural gas service. *See* 66 Pa.C.S. § 2206(d) (relating to consumer protections and customer service; consumer education). Section 2206(e) also provides for funding of consumer education by a non-bypassable competitively neutral cost recovery mechanism that fully recovers the reasonable costs of the program. *See* 66 Pa.C.S. § 2206(e) (relating to consumer protections and customer service; consumer education cost recovery). No amendment of the Natural Gas Choice and Competition Act is required if future consumer education would be deemed warranted.

4. Impact on Effective Competition – Educated consumers are an important component of a structure that facilitates competition. As to any broad consumer education efforts, the stakeholders agree that they should be commensurate with the scale of changes that result from the SEARCH process. If the changes to the competitive gas market are substantial with significant impacts on how consumers participate in the market, then the education efforts will likewise have to be more significant and visible. Also, it has been noted that consumer education should inform people about changes in the competitive market and how to benefit from these changes. Consumer education should not attempt to stimulate competition alone especially in the absence of competitive offers being available to the consumer.

5. Disadvantages and Costs – Consumer education necessarily causes costs to be incurred even if it is done effectively. Changing the term for "price to compare" to something more understandable would be fairly easy to implement.

D. Gas Procurement Costs Contained Within Base Rates

1. The Issue – Base rates contains costs attributable to gas procurement. These costs include salaries, benefits, administration, equipment, marketing and other related costs utilized in the gas procurement function. As a result, these costs are not included within the cost of gas calculations and therefore are not embedded in the price to compare. Base rates that contain costs attributable to gas procurement are viewed by some participants as an impediment to competition.

An option to address this problem includes 1) directing Section 1307(f) NGDCs to file a fully allocated customer class cost of service study that removes rate base and operation and maintenance expenses related to natural gas procurement from base rates and 2) creating a separate gas procurement surcharge to include these elements. In effect, through this process, the distribution rate would be unbundled. The gas procurement surcharge would be designed to be rate neutral, in that base rates would be reduced by a corresponding amount equal to the surcharge. In addition, the Section 1307(f) rate and the new surcharge would be added together to create a "price to compare."

2. The Position of the Participants - Gas marketers commented that customers who choose an alternative supplier currently pay twice for certain items because of the inclusion of gas procurement-related costs in base rates. As a result, they support the removal of gas procurement costs from base rates, but do not believe that a surcharge is necessary to do this.

OCA stated that it must be made clear that only avoidable, or incremental, procurement costs should be considered for inclusion in the price to compare, and argued that including a wide range of costs in the price to compare may simply artificially increase the cost to customers and not foster genuine competition. OCA agrees that these unbundled cost elements cannot be included in the purchased gas cost rate under Section 1307(f), but the use of a separate reconcilable surcharge is also not appropriate for recovery of these costs if any avoidable costs are shifted to the price to compare.

The NGDCs did not oppose the development of a reasonable price to compare by shifting non-SOLR gas procurement costs from the delivery charge to gas costs so long as those costs would be tracked and recovered. However, the NGDCs caution as to the degree to which such an unbundling should occur. It must be acknowledged that some level of gas procurement costs currently in delivery charges may be necessary for NGDCs to maintain basic SOLR functions which benefit all customers, whether they are customers of NGS or NGDC commodity service. One NGDC commented that the complete separation of costs exclusively related to gas procurement would be difficult, if not impossible. The proposed development of a gas procurement surcharge would be administrative challenging and would add to the NGDCs' cost of operation and rate charged to customers by creating yet another rate to be regulated and monitored by the Commission.

3. Requisites for Implementation - This proposal would require legislative amendments if the surcharge were to be included within the Section 1307(f) process. Alternatively, the gas procurement surcharge could be separate from the Section 1307(f) rate and the distribution charge. A mechanism would have to be designed for the NGDCs to change the rate whenever it was needed.

4. Impact on Effective Competition - This measure would remove an impediment to competition by ensuring that the "price to compare" contains all elements of gas procurement and enabling NGSs to offer consumers a competitive price for that supply service.

5. Disadvantages and Costs - The unbundling of the distribution rate to remove costs related to gas procurement would be administratively burdensome and time-consuming. Further, development of an additional surcharge for procurement costs would increase regulatory oversight.

E. NGDC Cost Recovery of Competition-Related Activities

1. The Issue - NGDCs should be able to recover reasonable costs that are prudently incurred in connection with the implementation of any changes designed to promote the development of effective competition. Such costs might include those associated with modifications to billing systems or consumer education activities.

2. Positions of the Participants - NGDCs support this concept and marketers are neutral. Consumer representatives expressed concerns about the level of any such costs, as well as resulting rate increases, and would need to be assured of receiving benefits from the measures being implemented. Any cost recovery outside the context of a base rate case is problematic for consumers.

3. Requisites for Implementation - At a minimum, NGDC recovery of reasonable costs prudently incurred as a result of competition-related activities would require a tariff filing by NGDCs. A Commission directive, followed by a regulation, would facilitate the filing of requests for recovery. It does not appear that a statutory amendment would be necessary.

4. Impact on Effective Competition - This measure should have a positive effect on competition in that it would provide the funding needed by NGDCs to implement certain measures to increase competition in the natural gas supply market.

5. Disadvantages and Costs - Allowing recovery of costs for competition-related activities may result in rate increases for distribution service and for supplier of last resort service (bundled supply and distribution service) offered by NGDCs.

F. Off-System Sales and Capacity Release

1. The Issue - The interplay among NGDCs and the interstate gas pipeline/gas storage system was suggested as a possible barrier affecting competition. For several years, the NGDCs have been participating in sharing mechanisms related to off-system sales and capacity release. Initially, these programs were created through Federal Energy Regulator Commission (FERC) Order 636 to commence a more economic distribution of unused capacity and were implemented by this Commission as temporary incentive programs that would assist in the reduction of demand costs. Over the years, incentives for the NGDCs have been added to enhance the usage of these programs. The incentives were designed so that the utility would retain a portion of the revenues received, while the remaining revenues would be used to offset the cost of gas.

Some participants view the off-system sales and the capacity release sharing programs as lucrative and having grown beyond their initial intent of developing a mechanism to reduce gas costs through the sale of unused capacity. The NGDCs' Section 1307(f) filings for 2007 indicate that during the prior year the NGDCs received $20 million as their share of the off-system sales and capacity release, which is below the line revenue that flows directly to the stockholders. The NGDCs' revenue share could be considered an impediment to competition since the NGDCs are using Section 1307(f) capacity (capacity that is paid for by the gas cost customers) to enhance their revenues. In addition, the off-system sales programs are competing directly with marketers for the same load, in that the NGDCs are bidding in the market for the same pipeline capacity that the marketers are bidding for and using to service their customers.

One suggestion is to eliminate the sharing mechanisms for off-system sales and capacity release and use the revenues received from off-system sales and capacity release to offset natural gas costs in the Section 1307(f) filings. Section 1307(f) ratepayers would see an immediate decrease in the cost of gas through the crediting of 100 percent of the off-system sales revenue and capacity release revenues.

2. The Position of the Participants - Marketers generally support this concept, claiming that NGDCs can use more expensive assets to serve sales customers and less costly assets for profitable off-system sales. OCA and NGDCs maintain that this approach is not worthy of further consideration, in the absence of concrete evidence or specific examples to support the view that off-system sales and capacity release programs are impediments to competition. The NGDCs argue that the return of retained revenues from off-system sales would produce no meaningful bill impact, and that the discussion did not consider that a sufficient level of pipeline capacity is needed to serve the peak demands of the residential and commercial customers in the winter months.

3. Requisites for Implementation - This measure would not require a statutory amendment, but would necessitate Commission orders and possibly regulatory changes.

4. Impact on Effective Competition - It is unclear whether this concept would enhance the development of competition.

5. Disadvantages and Costs – At this time, this approach has not been fully developed, and an assessment of disadvantages and costs has not been performed.

G. Standardization of NGDC System Operations

1. The Issue - Differences among NGDC systems in regard to their organization and operation have been identified as a barrier to supplier entry and full participation in Pennsylvania's retail natural gas market. For purposes of this report, interactions related to system operations (at times, asset management) involve the exchange of information between NGSs and NGDCs. These interactions entail the day-to-day activities necessary to assure reliable delivery of natural gas to customers on the system.

The "choice market" is comprised of shopping residential and small business customers[1] generally below a threshold of 6,000 MCF a year and is backstopped by SOLR service provided by NGDCs. The "independent market" is presently comprised of shopping large volume commercial and industrial customers and in most NGDC service territories is not backstopped by SOLR service; rather, SOLR service is rendered by the NGDCs on an "as available" basis to independent market customers. Historically, statewide, more than 90 percent of large volume industrial customers and 50 percent of the large volume commercial customers are served by the independent market suppliers.

Both choice and independent markets require certain interactions between the NGS and NGDC in order to assure natural gas delivery to customers on the system. The number of interactions required is dependent on the number of NGS customers served and the business relationship established between the NGDC and NGSs operating on its system. Fewer interactions are required between the NGDC and the NGSs in providing service to large industrial and commercial customers than would be required when serving a number of residential and small business customers.

Besides customer numbers affecting the frequency of interactions between the NGDC and the NGSs operating on its system, the asset management model or transportation program design adopted by the NGDC influences the business relationship between the parties, and thereby also affects the number of interactions between the parties. At present, the business relationship between the NGDC and the NGSs operating on its system can vary from NGDC to

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[1] Section 62.72 of the regulations defines a small business customer as a person, partnership, corporation, association or other business entity that receives natural gas service under a small commercial, small industrial or small business rate classification, and whose aggregate maximum registered annual consumption with the NGDC was less than 300 Mcf, or equivalent, over the last 12 months. 52 Pa. Code § 62.72.

NGDC and from market to market on the same system. These business interactions involve the management of system assets in regard to gas supply in the system. The purpose of asset management is to ensure reliable system operation and to support the delivery of the natural gas supply, provided by the NGSs at the city gate, to customers on the NGDC system.

In regard to the management of system assets, there are three general models. In one, the NGDC acts as a "parent" to the NGSs, performing all the functions necessary to ensure delivery of supply to the NGS customers. In the second, the NGDC and NGSs interact as partners, with varying degrees of responsibilities vested in each player. And, in the third model, the NGDC has exited the merchant function and acts as a common carrier for suppliers operating on its system.

In a parent relationship, the NGDC expects only one level of activity from the NGS, *i.e.*, a fixed level of day-to-day delivery of gas by a NGS. The NGDC handles all other responsibilities of asset management to assure reliable service to the customer. The parental relationship is also characterized by:

The NGDC taking responsibility that storage is filled and deliverable to the system;
Balancing on the interstate system being limited to a single element; and
Reconciliation of gas volumes taking place only at specific times.

In the second model, the partnership relationship between the NGDC and the NGSs is characterized by daily business interactions between the two regarding nominations, delivery, balancing, penalties, system operational forecasts, customer requirements forecasts and outlooks. There is an expectation that a NGS will respond as needed to stabilize conditions on a NGDC system. This relationship grows over time and is built upon trust.

Under the third model of system operation, the NGDC functions solely as a common carrier and possess no upstream assets for capacity or commodity.[2] Except for the delivery of natural gas from the city gate to burner tip, the NGSs are responsible for all asset management, which includes a shared liability to assure the firm supply of all NGSs operating at the city gate. This model is not currently in use in Pennsylvania.

As long as these responsibilities are well understood by the NGS and NGDC, either the parent, or the partner system is capable of assuring reliable service for customers. The asset management responsibility given to the NGSs determines the risk potential of the interaction, and can thereby affect the level of security that must be posted in order for a NGS (or the NGDC) to be deemed creditworthy.

2. Positions of the Parties - Both NGSs and NGDCs have demonstrated that they can operate in either the partner or parent environment and have expressed preferences for both systems depending upon their experience. In particular, the size of the NGS, its pool and its business plan could determine its individual preference for an asset management business interaction model. Even at the current level of interaction and responsibility, some marketers are willing to accept greater responsibility for managing assets and assuring service to their

[2] Establishing the NGDC as a common carrier would be consistent with the NGDC exiting the merchant function.

customers. A broader concern expressed by marketers is that the differences in operation among NDGC systems act as barrier to their entry and participation in multiple NGDC systems, and that some level of standardization would be helpful.

3. Requisites for Implementation - Requiring all NGDCs to migrate to a preferred model for managing system assets, including the scenario whereby the NGDC exits the merchant function and becomes a common carrier, would require comprehensive legislative changes and subsequent Commission proceedings to ensure due process related to property rights. Business practices governing interactions between the suppliers and the NGDC can be tailored to operate within the preferred model.

Alternatively, it may be possible to streamline and/or standardize certain interactions between the NGSs and NGDCs involving gas supply management on the NGDC system. These best business practices could be defined and memorialized in a generic supplier's tariff or promulgated in Commission regulations.

A subgroup of NGDCs and NGSs (including pipeline operators) considered the possibility of conforming NGDC-NGS business practices to those recommended by the North American Energy Standards Board (NAESB).[3] Participants of this subgroup reviewed each standard and business practice and identified areas of agreement and disagreement on eight operational issues that were being reviewed by the working group and are discussed in detail elsewhere in this report. These issues included NAESB wholesale gas nomination standards as well as retail business practices in nine areas:

Market participant interactions;
Creditworthiness;
Billing and payments;
Distribution company/supplier disputes;
Electronic Data Interchange and Internet Electronic Transport;
Quadrant-Specific Electronic Delivery Mechanism;
Contracts;
Customer Information; and
Customer Enrollment, Drop and Account Maintenance.

The NAESB subgroup reviewed each set of standards/business practices of each of these categories to determine if the standard or practice is already addressed by Pennsylvania rules, regulations and/or statute, is appropriate for consideration as a Pennsylvania business practice, may or may not be appropriate for Pennsylvania, or is not applicable.[4] The members of this

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[3] NAESB standards are federally mandated for the wholesale natural gas industry and some NAESB principles and related definitions are federal requirements while others serve as guidelines or are implemented on a voluntary basis.

[4] For example, the NAESB Nominations Related Standard 1.1.17, relating to the confirmation process, was identified as being appropriate for consideration as a PA business practice. Another area that was deemed appropriate for Pennsylvania relates to the features and functions of the NGDC Electronic Bulletin Board.

subgroup have differing levels of agreement as to whether certain standards or practices should be considered. This issue would require more exploration if it is to be pursued.

4. Impact on Effective Competition - Greater consistency of business interactions and supplier responsibilities among multiple NGDC systems, may make it easier to enter a NGDC market and secure customers on one or more NGDC systems. Further, the more that a NGS can rely on known standards and protocols for the expected interactions, the less chance there is for errors.

One way to create a competitive environment would be to require all NGDCs to adopt a preferred model with system operation and other business practices standardized across the state. A more workable solution may be to adopt certain NAESB procedures/rules to bring uniformity to NGS and NGDC interactions.

5. Disadvantages and Costs - Mandating that all NGDCs revise their system operations and business practices to one preferred asset management model would be a monumental task requiring the expenditure of considerable time and financial and political capital. Allowing NGDCs the option to exit the merchant function falls into this category. Large consumers expressed concern that any standardization must ensure continued benefit to large volume commercial and large volume industrial customers, and not detrimentally impact these customers.

Some NGDC business practices could be standardized through the adoption of NAESB practices in Commission regulations, or through their incorporation by reference in a generic suppliers' tariff. Such changes to NGDC business practices would require less time to implement and would incur lower costs because of previous work on NAESB that has already been completed.

H. Purchase of Receivables

1. The Issue - The NGDC's purchase of NGS receivables was examined as a way to increase supplier participation and expand customer participation in the retail natural gas market. In a Purchase of Receivables (POR) program, the NGDC purchases a NGS's accounts receivable, most often at a discount. The discount may be attributable to uncollectible expense, *i.e.*, bad debt of the NGS's customers, and the NGDC's administrative costs for billing and collection. NGDC implementation of these programs may be mandatory or voluntary. Terms of the programs, including purchase discounts, may be uniform across the state or individually negotiated by each NGDC.

Controlling the costs of bad debt could permit a NGDC to offer an undiscounted or low discount POR program. Strategies for reducing bad debt could include the NGDC's timely termination of service to customers whose accounts are in arrears, including the NGS gas supply costs, the restriction of customers permitted to shop for retail supply to only those that are creditworthy, and the implementation of a bad debt tracker and cost recovery charge separate from the purchased gas cost rate.

2. Positions of the Parties - The NGSs support the use of POR programs. The purchase of NGS receivables by the NGDC promotes efficiencies, reduces costs to customers, and reduces barriers to entry into the retail market, thus encouraging market participation by both marketers and all socio-economic groups of customers. The purchase of receivables creates greater consumer access to alternative supplier offers. Normally, only those customers with the highest credit ratings will be most attractive to alternative suppliers. In a POR program with low or no discount, credit rating is not a significant issue.

States with successful choice programs like Ohio and New York owe at least part of their success to the purchase of receivables programs. If the NGDCs are allowed to recover 100 percent of their costs either through their base rates or a bad debt tracker coupled with a cost recovery mechanism, marketers should not need to incur a discount on the purchase of their receivables. The NGDCs should be allowed to terminate non-paying customers when they buy the marketers' receivables. Limiting bad debt exposure should decrease or eliminate any discount that the utility would make in its purchase of receivables.

With the volatility in the natural gas market, moving from an average of approximately $2/MCF in the late 1990s, to over $10/MCF today, uncollectible expenses have changed significantly so that NGDCs may not be currently recovering the full amount in the purchased gas cost (PGC) rate. In the event that the NGDCs cannot recover 100 percent of their uncollectibles, it is the marketers' alternative recommendation that these uncollectible expenses be transferred from base rates to inclusion into their gas commodity costs and be recoverable through this mechanism.

The marketers propose the creation of a mechanism to track bad debt, outside of both the PGC and the base rates. Identifying the true total amount of uncollectible expenses would allow for the establishment of a cost recovery mechanism to recover costs from all customers. Since bad debt will be recovered through a recovery mechanism, the NGDC can offer a POR program without a discount for this expense.

One NGDC agrees with the marketers' proposal for a bad debt tracker. If a bad debt tracker cannot be established, the marketers' proposal for unbundling the PGC to create a merchant function charge is a reasonable (and achievable) alternative. A POR program without a bad debt tracker would require the application of a discount equal (at a minimum) to the NGDCs' projected level of uncollectible expenses if NGDCs are not permitted to discontinue service for non-payment to all customers. The NGDC states that the marketers' suggestion for an arbitrary discount (*i.e.*, 1 percent) coupled with enrollment restrictions based on a customer's creditworthiness would, for no apparent reason, deny payment-troubled customers access to competitive markets. NGDCs should be permitted, but not mandated, to enter into POR programs upon commercially reasonable terms. NGDCs state that they should have the option of not including NGS "nonbasic services" (as defined in section 62.72) in their purchase of receivables program.

The NGDCs commented that they are obligated to accept all customers whereas NGSs can reject customers and, therefore, can better manage their own risk. They warned that mandatory POR programs could increase NGDC uncollectible expense. A POR program that allows NGDCs to treat the NGS's customer no differently than its own customers levels the playing field and is most fair for consumers. Such programs should be voluntary, and there should be no mandated terms and conditions for voluntary POR programs.

One consumer representative expressed disagreement with the use of a separate bad debt tracker in conjunction with a POR program and argued that uncollectible expenses should be included and recovered in base rates. The representative also opposed the sharing of uncollectible expense equally among customer classes because bad debt does not track equally among customer classes.

OCA maintained that a POR program should only be considered in lieu of, rather than in addition to, transferring costs from distribution rates to the price to compare. Discount rates should address all risks and administrative costs so that none of these risks or costs is transferred to distribution customers. Also, OCA maintained that low-income customers should retain the right to buy from marketers.

A consumer representative also expressed the opinion that any discount in a POR program should be updated to reflect the savings achieved by the use of notice and termination procedures provided by Chapter 14[5], specifically 66 Pa.C.S. § 1406[6].

3. Requisites for Implementation - The Commission may have the authority to mandate that NGDCs implement POR programs, although this question has never been presented to the Commission or the courts. In implementing a mandated program, the Commission must take into account the provision at 2205(c)(5) of the Public Utility Code, which states that the billing NGDC is not required to forward payment to an entity providing services to customers before the NGDC receives payment for those services from customers. 66 Pa.C.S. § 2205(c)(5). In any event, there is no question that the Commission has the authority to implement PORs as voluntary programs and may prescribe statewide standards for such programs. See 66 Pa.C.S. § 501 relating to general powers.

Currently, one NGDC has voluntarily entered into programs of its own with NGSs on their systems. Generally, these plans allow the NGDC to negotiate terms with the NGS participants. Chief among these terms is whether NGDCs would purchase receivables at 100 percent or at some lesser value.

Once the NGDC has purchased the receivable, the question becomes what it can do to collect the debt. For instance, should the NGDC be able to terminate service to a customer for non-payment of a debt which the NGDC has purchased from a NGS on its system? Currently, the Commission does not permit NGDCs to disconnect service as merely a collection device, particularly with respect to receivables purchased from a NGS. *Guidelines for Maintaining Customer Services at the Same Level of Quality Pursuant to 66 Pa.C.S. section 2206(a), Assuring Conformance with 52 Pa. Code Chapter 56 Pursuant to 66 Pa.C.S. section 2207(b), section 2208(e) and (f) and Addressing the Application of Partial Payments,* Docket No.M-00991249F003, tentative order entered August 27, 1999, at 16-19. The Commission would have

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5 Chapter 14 of the Public Utility Code relates to "Responsible Utility Consumer Protection."

6 Section 1406 specifically relates to termination of utility service.

to rescind aspects of this order in order to allow NGDCs to use termination as an incentive to collect receivables purchased from NGSs.

The next consideration is how, and if, NGDCs would recover uncollectible expense related to purchased receivables. The Commission could allow NGDCs to include this debt as uncollectible expense in a base rate case. In addition to the matter of timing rate cases, such an expense allowance would place costs unrelated to the NGDC's distribution or sales services into base rates where they would be borne by all customers, including those who do not shop. This raises a question of fairness. Although the utility must meet certain requirements and the customer must fail to meet minimal payment requirements as well as set forth in Chapter 14, and applicable Commission regulations in Chapter 56, eventually the NGDC can withhold service. Again, termination of service is a strong incentive to compel payments.

The NGDCs might collect this bad debt expense through the use of a debt tracker and the establishment of a cost recovery charge paid by all shopping customers. The bad debt charge would be billed to customers as a separate item not included in the PGC. However, establishing a bad debt tracker and separate cost recovery charge would require a change to Section 1408 of the Public Utility Code that currently prohibits surcharges for uncollectible expenses. 66 Pa.C.S. § 1408.

Rather than mandating a uniform POR program for all NGDCs, another solution would be to allow the NGDCs to purchase receivables at a negotiated discount rate. The NGDC would be responsible for any amounts which remain uncollected. Thus, the utility would bear any losses in this program and, conversely, should be allowed to keep any gains. If it buys debt, for example, at 90 percent of its value and collects 93 percent of the value, it would keep the additional 3 percent.

Also, as a component of a POR program, the NGS may be able to sell or pledge a portion of its receivables as an alternate form of security to a surety bond or letter of credit. This alternate security would support business interactions between a NGDC and a NGS, and would fulfill the NGS's statutory security requirement to maintain its NGS license. Such a provision may be negotiated between the NGDC and the supplier.

Finally, rules should be established that would prevent customer gaming of the system. The rules would prevent a customer who is 90 days in arrears or who has used energy assistance payments within the prior 24 months from shopping for natural gas. Additionally, shopping customers who become 90 days in arrears on their commodity bills could be returned automatically to the NGDC.

4. Impact on Effective Competition - The creation of a POR program would encourage market participation because it would put marketers and NGDCs on a more equal footing, and would enable NGS to more easily compete with the NGDCs for gas customers. With the use of a bad debt tracker and establishment of a bad debt cost recovery charge, customers from all economic circumstances would be eligible to participate in the natural gas retail market and purchase natural gas supply from marketers.

5. Disadvantage and Costs - The NGDC's costs to implement and operate a purchase of receivables program should be minimal, being restricted to increased administrative costs over and above customer service costs already incurred by the NGDC to provide billing and collection services to those customers who purchase gas supplies from marketers. Costs related to the bad debt of the suppliers' customers will vary between suppliers and will be taken into account by the NGDC in establishing the price that it will pay for marketer accounts receivable.

Establishing statewide standards for POR programs in the form of tariff rules or through the promulgation of regulations would be a time consuming process. Moreover, the administrative proceedings and necessary regulatory review process involved to promulgate standards for POR programs may cause the Commission and all participants involved to incur substantial administrative expense and legal costs.

I. Creditworthiness/Security

1. The Issue – The creditworthiness and financial security requirements established by NGDCs are viewed as barriers to NGS participation in the retail market. Providing financial security is often a component of commercial transactions where one party incurs an obligation to another party, and needs to provide assurance this obligation will be performed even if the party incurring the obligation becomes insolvent, defunct or otherwise decides not to perform and cannot be easily sued for damages. This assurance is generally provided by third parties, such as insurance companies or corporate parents under terms that provide assurance that the underlying obligation will be satisfied in the event of insolvency or bankruptcy. The agreements governing the provision of security by third parties, such as bonds, letters of credit or corporate guarantees, memorialize the terms under which the guarantor is willing to provide performance assurance. Other forms of security that may be used include security deposits, mutual agreements, cash escrow accounts, and interests in real and personal property.

Section 2208(c) of the Public Utility Code establishes the security requirement for the issuance and maintenance of a NGS license. 66 Pa.C.S. § 2208(c)(1). The criteria for use by the NGDC to set the amount and form of the security were established in each company's restructuring filing. Upon petition of a party, the Commission may review these criteria. If a NGDC and NGS cannot come to a mutual agreement, the level or form of security is determined by criteria approved by the Commission. *See* 66 Pa.C.S. § 2208(c)(1). Consistent with its statutory obligations, the Commission promulgated regulations defining the criteria to be used to determine security levels when voluntary agreement is not reached, specifying permissible legal and financial instruments to be used in providing security and other related matters. *See* 52 Pa. Code §62.111.

The level of security is based on a formula that takes into account the NGDC's exposure to costs. For the retail supply market, this formula involves the peak day demand estimate for capacity, number of days' potential exposure in a billing cycle, and commodity estimates for quantity and cost. Offsets to the amount of security that a NGS must provide may include calls on capacity, receivable purchases or receivable pledges. NGDC costs related to supplier default as set forth in Section 2207(k) of the Public Utility Code may also be taken into account when establishing the amount of security required. 66 Pa.C.S. § 2207(k).

A financial review of the supplier's credit worthiness for the adjustment of the security level is done annually, but some supplier tariffs permit review at the NGDC discretion. Security levels may also be reviewed and adjusted on a seasonal basis. When the formula used is tied to winter service levels (the predominant assumption), the transactions are over-collateralized during the summer months.

Currently, the NGDC reviews the supplier's creditworthiness using Dun & Bradstreet Ratings, Moody Ratings and Standard & Poor ratings for publicly traded companies. A request is also made for financial statements from non-public companies, and a parent company's data may be reviewed.

The use of a surety bond, letter of credit or escrow account for a market entrant assures the NGDC of recovery of its reasonable costs relating to possible default of the new supplier. However, the NGDCs have experienced problems with language of the bonds as well as the expense of trying to collect on the bond. There is little or no commercial standardization of surety bonds, and virtually no regulatory oversight, enabling issuers to unilaterally impose adhesion contract terms and conditions on third party obligees, in this case, the NGDCs. NGDCs typically have little or no role in drafting the provisions of surety bonds, especially renewals.

Collection of claims against surety bonds, which often involves litigation, is a slower, more burdensome and more costly process than collection of claims due on alternative financial instruments. Moreover, guaranty parties other than the bond's issuer may become involved in litigation, adding new parties and new issues that may further complicate legal proceedings (particularly those involving bankruptcies).

2. Position of the Parties – Marketers observed that the use of security instruments is not uniform among the companies and that variability is a barrier to market entry and multi-system participation. They also raised concerns about the cost of security, noting that the cost of the bonds became excessive as their sales grew. They further stated that there should be a limitation on the frequency of review of required security levels, with specific triggers for that review, such as a percentage change in pool size.

The acceptance of only certain financial instruments is also viewed by marketers as a barrier to market entry. The preference of marketers would be to use corporate guarantees as the predominant practice. Further, to ensure fairness and remove a possible barrier for market entry, specific criteria for acceptable financial instruments should be established in a regulation or Commission order rather than permitting companies to set those through tariffs.

In addition, it was suggested that participation in the market is hindered because of the many levels where security is required to complete a transaction. Specifically, a marketer may need to post security to pay for gas from the producer, to move gas on the interstate pipeline and to move gas on the NGDC's system. The use of either receivable purchases or pledges would eliminate at least one level where security would be needed.

The level of security is based on a formula that takes into account the NGDC's exposure to costs. For the retail supply market, this formula involves the peak day demand estimate for capacity, number of days' potential exposure in a billing cycle, and commodity estimates for quantity and cost. Offsets to the amount of security that a NGS must provide may include calls on capacity, receivable purchases or receivable pledges.

Purchase of NGS receivables may be viewed as an alternative to other types of financial instruments. Receivables are a current asset of the NGS that reflects money owed to the NGS by customers. The pledging of receivables is a traditional means to provide working capital to an enterprise, and is customarily referenced to credit card style asset backed securities. In practice, the purchase of the receivable by the NGDC will be viewed as positive in support of the pledge of receivables for short term financing, as cash, though discounted, will move to the marketer, absent the open risk of collection. Effectively the discounting ameliorates the collection risk providing stability to the marketer. The purchase of receivables by a NGDC would take into account any pledging of the receivable by the marketer, with the pledge of receivables being subordinated to the purchase of receivables.

For initial or small operations, the surety bond should remain an option, but both NGDCs and marketers agree that surety bonds are not the preferred type of security because of the expense involved. Either a letter of credit or cash escrow for security is preferred by NGDCs for initial market entrants. However, once a working relationship has been established, NGDCs are not adverse to the use of corporate guarantees. Additionally, the parties generally agreed that the pledge or purchase of receivables removes the majority of credit issues once a reasonable discount is used.

3. Requisites for Implementation – Changes to the Public Utility Code and the Commission's regulations would be required. The provision of security to the NGDC by the NGS is a statutory requirement for maintaining a NGS license. 66 Pa.C.S. § 2208 (c)(1)(i). This section also permits the NGDC to determine the amount and the form of the bond or other security using criteria that is subject to periodic review by the Commission. Such review can be requested by a petition. 66 Pa.C.S. §2208(c). Accordingly, the Commission has the authority to review criteria used by NGDCs to establish the form and level of security, including the use of the pledge or purchase of receivables as an alternate form of security. *See also*, *UGI Utilities, Inc. – Gas Division vs. Pa. PUC*, 878 A. 2d 186 (Pa. Cmwlth. Ct. 2005) (the Commission has discretion to approve criteria to be used to determine the financial security necessary based upon financial impact on the NGDC by a default by a NGS).

Commission licensing regulations at 52 Pa. Code § 62.111(c)(2) list the following financial instruments as acceptable security for licensing:

Bond;

Irrevocable letter of credit; and

Corporate, parental or other third party guaranty.

Section 62.111(c)(3) also permits real and personal property to be used as security when accompanied by (1) documentation that the licensee has a clear title to the property and that the property has not been pledged as collateral, or otherwise encumbered in regard to any other legal or financial transaction and (2) a current appraisal report of the market value of the property. It is noted that personal property would include a cash escrow account or a pledge of accounts receivable.

4. Impact on Effective Competition - Establishing standard language for the form of the financial instrument and reasonable criteria for the amount of security should assist NGSs in obtaining security in an acceptable form and amount, while aiding the NGDC in collecting a claim against the security in the event of supplier default. NAESB form and business practices could be reviewed for appropriateness to develop uniform language to address this issue.

The use of a POR program can also lessen the need for a credit review and an adjustment in security level that might normally be triggered by changes in a company's creditworthiness rating, which can occur for reasons unrelated to its immediate business interaction and relationships. The trust and confidence established between the NGDC and the NGS as a result of the POR program may reduce the need for creditworthiness reviews and the posting of additional security when credit ratings of the NGS or its parents are downgraded for unrelated reasons.

A POR program can enhance a marketer's creditworthiness so that the marketer could move to a position where after the fact payment for gas delivery could be made. Small marketers could use the NAESB Funds Transfer Agent program to accomplish this. A POR program can also open credit for a marketer so that it can pursue other ventures and expand its participation in the retail market.

5. Disadvantages and Costs – NGDCs would incur some costs to standardize their security requirements and may lose some flexibility that is currently used to address particular situations. The disadvantage to using a POR plan is loss of customer business and profit from the sale of gas supply for the NGDC.

J. Nomination and Delivery Requirements[7]

1. The Issue – In regard to nomination and delivery requirements in general, the type of relationship established between the NGDC and the NGS dictates the frequency of daily information exchanges on nominations and deliveries. In the partnership type of relationship, where a NGS is expected to manage supply, capacity and storage assets, information exchange is expected on a more routine and regular basis. In the situations where the NGDC acts as the parent and is expected to manage the array of assets, there is less required communication and hence, less interaction.

Under the parent relationship, there is no adjustment to daily nomination and delivery except for the addition and deletion of customers. The NGS is expected to deliver 1/365 of the annual requirements of the customer each day and the NGDC manages the movement of gas among the assets on its system to make the delivery to the customer while maintaining system

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[7] Collateral to this overall discussion of nominations, deliveries, tolerance bands, cash out and penalties, is the working group's review of NAESB business practices for the retail gas market.

reliability. Hence, for that process, there is no communication for daily nomination and delivery changes between the NGS and NGDC. The NGDC manages the assets itself or its customers are exposed to the penalties that may occur.

Under a partner relationship, it is essential that the NGDC and NGS communicate in advance of each gas day cycle for nomination. The NGDC provides the NGS with outlooks for its customer pool, based upon weather forecasts and recent patterns of consumption activity. The NGS then utilizes that information together with its intelligence to formulate its gas day nomination. Unfortunately, the timing for the main gas day nomination is different for each NGDC. Under NAESB wholesale rules, four nomination cycles can be used to communicate information on gas required movement. In most cases, NGSs are only permitted to use the main cycle and can not make intraday nominations. Because these nomination periods could be used to adjust flows, the NGS is exposed to a greater risk of balancing penalty due to the mismatch of nominations and deliveries. At this time, no NGDC provides a NGS with the opportunity to use all of its nomination cycles.

The information transmitted in a NGS-NGDC interaction is an estimate of maximum daily quantity (MDQ) provided by the NGDC to the NGS. This initial information is based upon historic information, and is tied either to an individual customer or profile of a customer or to the pool. The information is then modified by weather forecasts and grossed up for natural gas that is kept by the NGDC to recover "lost" or unaccounted for natural gas (retainage). This creates a Daily Demand Quantity (DDQ) nomination that the NGS is expected to deliver. Differences between actual deliveries and nominations can be met by either pipeline “park and loan” services, no notice services or NGDC balancing services. This communication will also reflect assigned capacity, pipeline delivery point specification and other information necessary for the NGS to move gas from its supply point to the city gate. On-system locally produced gas, identified as a source by the NGS, would be separated out by the NGDC and be reflected in the city gate requirements. Depending upon the NGDC and its assignment program, specifications for use of storage gas versus flowing gas would also be communicated. Because a NGS may use an alternative supply region instead of a NGDC, the capacity assignment is back to a basis hub rather than a specific field. This use of separate supply regions has provided reliability benefits to a NGDC’s firm customers. This most recently occurred in post Hurricanes Katrina and Rita conditions that disrupted historic production areas.

From the DDQ nominated, the NGS is expected to deliver within tolerance bands as specified in the supplier tariff or operations manual. Delivery of quantities of gas in excess of or short of the tolerance band creates the potential for penalties. For choice customers or choice pools, these daily balances are netted to monthly factors that are cashed in or cashed out. Two NGDCs appear to permit the monthly balances to roll and actually net the balance on an annual settlement basis. NGSs expressed a preference in general for wider tolerance bands and the opportunity to roll balances rather than cash out. However, NGSs did not like the annual settlement process because of the amount of NGDC risk they could accumulate through the process. There is not a general practice of balancing choice customers or pools on actual burner tip quantities. Part of this is due to the fact that a choice pool is not segregated into its own specific billing cycle, hence, absent advanced metering, there will always be a mismatch at the measurement of burner tip quantities to the nominated and/or delivered quantities. Additionally, although the billing factor is constant, retainage or unaccounted for gas is not static.

Ultimately, the sum of the DDQ leads to the MDQ as nominated and delivered. The MDQ acts as the primary billing variable for the settlement of accounts between the NGS and NGDC. The tolerance bands are tied to the MDQ where only monthly metering is available, which is the case for the majority of customers. In situations when volumes of gas delivered fall outside the tolerance bands, the situation is corrected based on the terms of balancing agreements or by imposing penalties.

2. Positions of the Participants – The NGSs referenced difficulties in operating on different NGDC systems due to the lack of uniformity in aggregating customer load (six of the eleven supplier tariffs do not specify aggregation requirements), varying supplier tariffs, both from the standpoint of the rules and where various provisions are addressed in the tariffs, the integration of supplier and retail tariffs by some companies, variations in the terms and conditions applicable to pooling, differences in the application of nomination and delivery requirements, departures from interstate pipeline practices that are aligned to the NAESB wholesale gas quadrant standards, and inconsistent balancing rules and tolerances. These variations require NGSs to train their employees to understand the unique practices of each system, which delays its full participation in a particular market while also hindering entry into multiple markets. Also, from a market power standpoint, the lack of uniformity can create unfair treatment or even arbitrage opportunities when supplies or capacity are constrained.

The NGSs proposed a best practice relating to nominations cycles, and suggested that NGDC practices be coordinated with those of the respective interstate pipelines, which are aligned to the NAESB wholesale gas quadrant uniform standards. The NAESB pipeline industry standard is four nomination cycles:

Timely Cycle (due 12:30 p.m. prior to the day of gas flow);
Evening Cycle (due 7 p.m. prior to the day of gas flow);
Intraday 1 (due 11 a.m. day of gas flow); and
Intraday 2 (due 6 p.m. day of gas flow).

Although times may vary slightly among pipelines, all pipelines have at least these four cycles. According to the NGSs, during normal operating conditions on the NGDC system, the four nomination cycles, although with slightly later timeframes than the interstate pipelines require, should be available. With these cycles, a commercial and industrial transportation customer has the ability to change nominations three additional times after making the initial nomination. The need to change a nomination can occur for numerous unexpected reasons, such as a change in weather conditions, in production schedules, a pipeline or NGDC system interruption. When multiple nomination cycles are provided, the transportation customer has the same ability as the NGDC's own internal supply operations personnel to manage load requirements and maintain supply stability when unanticipated changes occur. Additionally, allowing NGSs to operate under the same operating parameters as NGDCs in coordinating supply to the city gate benefits all customers because it improves overall system reliability.

Although the NGSs believe that four nomination cycles should be the standard for all Pennsylvania NGDCs, they suggest that, if a NGDC can reasonably demonstrate why it is unable to provide four cycles, at a minimum the Timely Cycle should be available with at least one Intraday Cycle. Allowing four nomination cycles in line with the pipeline industry standard should not create operational concerns for NGDCs. Existing tariffs already provide the NGDCs with the ability to control the manner and extent to which transportation customers (and NGSs) deliver gas into the NGDCs' systems. Adding the four cycles for nominations would likely be accomplished through incorporating additional windows on the NGDC's Electronic Bulletin Board (EBB). Alternately, if an EBB does not exist, then the NGDC would simply establish pre-arranged schedules with NGSs.

The NGDCs note that there is a distinction for nomination requirements between the Choice and the independent markets. Currently, nominations occur approximately 12 hours before the gas flow day begins. NGDCs assert that it is rare that weather forecasts and actual weather vary to such an extreme degree within this brief period of time that it affects a nomination amount. In such rare occurrences, a NGDC often factors this into whether or not it enforces respective tariff provisions (the same is true for interruptions). Generally, NGDCs prefer not to use all four nomination cycles. NGDCs also prefer to finalize their daily gas plans as early as possible in order to assure overall system reliability. When unexpected reasons such as a change in weather conditions or interruptions affect NGS nomination amounts, flexibility is generally provided to NGSs on an informal basis. NGDCs claim that if the NGSs are permitted to use four nomination cycles, it will also permit NGSs to abuse the more expansive nomination process.

3. Requisites for Implementation - To implement changes to nomination rules and delivery requirements and customer pooling or aggregation requirements, individual NGDC supplier coordination tariffs would need to be reviewed and amended. To establish uniform rules governing such matters, a Commission investigation could be undertaken. The uniform rules could be issued as a model/generic supplier coordination tariff or promulgated in Commission regulations.

4. Impact on Effective Competition - The elimination of inflexible or unreasonable nomination rules and delivery requirements that are not based on reliability concerns or NGDC system physical constraints would encourage supplier participation in the natural gas retail market. The standardization of rules for nomination and delivery requirements across NGDCs in general could lower operational costs for suppliers and could facilitate participation in multiple NGDC markets.

5. Disadvantages and Costs - No estimates of costs necessary to implement the NGSs' multi-cycle or intraday cycle proposals have been made, but it is anticipated that the costs would be company specific and uniquely dependent on the individual NGDC's current level of system investment. Some NGDCs may be able to implement such changes at less cost than others.

More advanced interactions between the NGDCs and the suppliers in regard to nominations and deliveries would also entail investment in software enhancements and potential personnel increases. The nomination and delivery interactions may also necessitate changes in operational requirements, most likely in regard to tolerance bands and penalties. Additional costs incurred to implement four nomination cycles, or an intraday nomination cycle, including those related to increased NGDC personnel requirements could be spread across all customer classes.

K. Tolerance Bands[8]

1. The Issue – At issue is whether tolerance bands and associated program design should be changed to promote choice. Tolerance bands, or balancing allowances, establish the permissible variations between nominations or use and actual deliveries over a period of time. To accommodate such variations, NGDCs must retain gas supply assets, such as storage or swing services to accommodate the variations, without using the gas supply assets of other users of the system. The costs of assets are generally charged to transportation customers in the case of independent markets, or to choice suppliers in the case of choice markets, under the tariff provisions of NGDCs. Penalties are assessed by NGDCs to discourage exceeding tolerance bands, and excess gas delivered or used is purchased or sold in cash-in/cash-out transactions. The particular balance between a NGDC retaining assets to provide a wider tolerance band and the permissible tolerance band can be referred to as "program design."

Tolerance bands represent an operational flexibility accorded to transactions to accommodate the timeframes for actual movement of gas on a system or pipeline and the inherent measurement variations and recording lags associated with that movement. Gas moves on the interstate system daily and is settled daily and monthly. This can create issues for gas movement both in priority and cost. Gas moves on a firm and interruptible basis; under assignment and release basis; and under short-term and long-term contracts. This array of asset management possibilities demonstrates the need for a tolerance band for the measured difference between what is nominated and delivered. Current Pennsylvania practice regarding tolerance bands, for both monthly and daily balancing programs run the spectrum from being based on tolerances of individual customers to being based on customer pools with bands of 2.5 percent up to 5 percent and 10 percent.

2. Positions of the Parties – Some NGSs claim that overly narrow tolerance bands are a barrier to competition. The NGSs provided the following examples of tolerance bands for reference. Baltimore Gas and Electric (BGE) in Maryland allows its NGSs a tolerance of two times their customer's daily usage (daily usage is calculated as the highest of five of the previous seven days). In Maryland and Virginia on Washington Gas Light's system they institute a daily plus or minus 15 percent band within which NGSs have to operate. AmerenIP in Illinois agreed during its last rate case to a 20 percent band within which no daily cash outs occur. In New Jersey, PSEG utilizes a winter model (where daily balancing is followed during winter only) with a 10 percent tolerance. A NGS has a 10 percent tolerance short. In other words, the NGS must bring in 90 percent of its customers' usage. Outside the 10 percent tolerance on the short side, a penalty will be imposed. There is no penalty for being long, but month end imbalances will be cashed out at 90 percent of the Z6 New York average for the month. Month end short positions will be purchased by the NGS at 110 percent of the Z6 New York average.

8 Collateral to this overall discussion of nominations, deliveries, tolerance bands, cash out and penalties, is the working group's review of NAESB business practices for the retail gas market.

NGSs prefer wider bands, while NGDCs favor closer bands. The NGSs propose following a best practices approach for tolerance bands. Tolerance bands should reflect a NGDC's realistic expectation that the NGS will deliver, during normal months, close to their "expected" customer usage amounts. It is unnecessarily punitive to hold NGSs to a higher standard than that which the NGDCs hold for themselves. Additionally, overall system integrity should be considered when formulating appropriate tolerance bands, as well as cash outs and penalties discussed below.

The breadth of the tolerance band diminishes substantially during an Operational Flow Order (OFO). Just as a tight bandwidth is reasonable during an OFO, a credible, properly structured bandwidth should be utilized during normal gas supply conditions. Tolerance bands should not be so tight that the failure of the NGS to remain within the band creates an "economic windfall" for the NGDC. Industry standards point toward tolerance bands of at least plus or minus 10 percent to plus or minus 20 percent. If a NGS's position in regard to gas delivered is on the opposite side of the overall system imbalance, then that NGS should not be penalized since its actions have helped preserve system integrity.

Of the balancing and tolerance bands in Pennsylvania, the marketers referred to the Dominion Peoples' monthly balancing requirements for NGSs serving commercial and industrial customers as representing an example of a well-structured program that combines the more efficient monthly balancing with the ability to aggregate pools. Where a daily balancing program is demonstrated to be necessary, the NGSs believe that the best practice is to allow reasonable, achievable tolerance bands with penalties being applied only outside those bands. They acknowledge that monthly tolerance bands can be tighter than daily bands because monthly balancing occurs over a month's time during which imbalances can be rectified, especially when imbalance trading behind the city gate is permitted. The marketers claim that tight tolerance bands on a daily basis only punish for the daily swings that naturally occur and cannot be controlled.

A desirable feature available on another system provides NGSs with the opportunity to trade imbalances behind the city gate. This practice recognizes and correlates the actual interstate pipeline activity with the city gate activity. With multiple NGS operators behind a city gate, there is the potential that each could incur tolerance band violations resulting in penalties, yet the city gate would be in balance due to offsetting conditions. Allowing NGSs to trade imbalances behind the city gate recognizes this reality, and thus makes it easier for NGSs to comply with tolerance bands to avoid penalties.

NGDCs note that tolerance bands or balancing requirements cannot be altered without modifications of transportation program designs. Increasing tolerance bands significantly without associated increases in gas supply assets and cost recovery mechanisms would jeopardize system reliability and cause unfair cost shifts to other firm transportation customers, including PGC customers. Under such a scenario the transportation customers using the unsupported wider tolerance bands would be using gas supply assets procured and paid for by other system users, and could cause potential curtailments of service at times of peak system demand.

NGDCs also note that independent markets have been in place for decades and have worked well and that a substantial number of customers already procure natural gas supply services from other sources. They note that imbalance penalties designed to encourage transportation customers to remain within tolerance bands under established program designs are primarily flowed back to PGC or firm transportation customers, and thus existing rules do not create an "economic windfall" for NGDCs.

While it is possible that two imbalances may offset each other, permitting such off-sets in an uncoordinated fashion could encourage behavior that would impact system reliability. The rights of other system users could also be affected since transporters would have a strong incentive to engage in arbitrage activities with the hope that they could escape system penalties, leading to system imbalances and reliability concerns. Most NGDCs in Pennsylvania already allow coordinated bilateral trading of imbalances since such coordinated trades can be accomplished without impacting system reliability or encouraging behaviors that could impact system reliability.

Since current tolerance bands have been established and used for long periods of time, NGDCs noted that information and other systems have been developed to operate within the existing bands, and incremental costs would have to be incurred to modify those systems to accommodate new system designs.

NGDCs noted that through the annual PGS process or in base rate proceedings, public advocates actively seek to ensure that transporters pay for their use of PGC assets when transporters exceeded established tolerance bands.

3. Requirements for Implementation - All of the practices and service conditions in place in Pennsylvania are the result of Commission decisions and have been established by each NGDC's restructuring settlement, system design and historic practices. Independent market rules have been established in rate or other proceedings before the Commission consistent with the Commission's gas transportation regulations at 52 Pa. Code §§ 60.1-60.9. Choice rules have been primarily established in gas restructuring proceedings. The Commission's regulations at 52 Pa. Code § 60.4(a) and (b) establish a rebuttable presumption that costs associated with transportation services may not be recovered from other customers through either base or PGC rates. Accordingly, these regulations may need to be modified.

Individual NGDC rules regarding tolerance bands that are not dictated by physical and operational constraints of a company's system may be modified by Commission order, after notice and an opportunity to be heard. *See* 66 Pa.C.S. § 703(e). Because suppliers can bring in non-utility assets to address local emergency conditions to solve the balance equation on the interstate pipelines, any change to current practice rules must not discourage suppliers from providing positive system reliability support.

4. Impact on Effective Competition - The adoption of wider tolerance bandwidths, along with other rules affecting natural gas flow on the NGDC systems, could lessen the possibility that NGSs operating on the system will incur penalties for imbalances of gas supply. Broadening the tolerance bands to a reasonable width affords the NGS more flexibility in providing supply volume and in making business decisions in regard to the expansion of its sales activities. The actual impact on effective competition will depend upon the adoption of a proper system operations model and tariff design.

5. Disadvantages and Costs - The adoption of unreasonably broad tolerance bands could jeopardize NGDC system integrity and service reliability. Also, broadening tolerance bands could require larger balancing charges as NGDCs must acquire and need to recover the costs of increased gas supply assets to provide wider tolerance bands. It is not clear that it would be equitable to require all transportation customers to pay for wider tolerance bands that would benefit only certain NGSs or transportation customers.

L. Cash Out/Penalties[9]

1. The Issue –Cash out and penalties are two fundamental controls used by NGDCs to encourage NGSs' actions to be consistent with NGDC expectations. Cash out is a term applicable to a settlement payment for gas purchased or sold between the NGDC and the NGS in order to balance system supply. Penalties act as a deterrent to the NGS to manage its gas supply on the NGDC system so as not to fall outside the tolerance bands established to maintain system integrity.

The NGDC cash out and penalty practices came about as a result of the Commission's effort to insulate the 1307(f) SOLR customers from exposure to supply and pricing fluctuations attributed to supplier interaction on the system. The balance that was struck is a legacy to the NGDC asset management of the SOLR account. A primary objective has been to compensate these customers for use of their assets to balance the system.

In general, most NGDCs utilize cash out prices that require NGSs to buy gas for short positions at the highest of one of the more costly index prices, and then magnify it by applying a multiplier greater than 100 percent. Long positions are then "cashed out" at the lowest index prices further discounted by applying a multiplier that is less than 100 percent.

2. Positions of the Parties - The marketers view the management of NGS gas supply on the NGDC system as a barrier to increased market activity in Pennsylvania. In particular, they view cash out and penalties for under and over delivery of gas to be key elements of NGDC system operations that need to be revised.

They suggest a number of actions that could be taken in regard to cash out such as the use of visible market indexes for the price settlement of any cash out or penalty, either short or long. A number of NGDCs do use local indices such as the Appalachian Basin Index as a starting point. However, a number still use a weighted average cost of gas for the settlement process. This is an older style practice that may not tie well to market information that is used for day to day purchase decisions.

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9 Collateral to this overall discussion of nominations, deliveries, tolerance bands, cash out and penalties, is the working group's review of NAESB business practices for the retail gas market.

The NGSs propose elimination of daily cash out in favor of monthly cash out as a preferred best practice. They believe that the monthly cash out would provide them with the opportunity to fully use pipeline services such as "park and loan" to manage gas supplies and minimize their penalty exposure. Daily penalties would be imposed only during system emergencies expressed as operational flow orders.

In regard to cash out, there was not strong opposition to the use of a common transaction index as the basis for cash out. However, NGDCs prefer some level of strong penalty and potentially punitive structure for actions adverse to system reliability.

3. Requisites for Implementation - Rules regarding cash out and penalties appearing in a NGDC's supplier coordination tariffs may be reviewed and amended as may be necessary by the Commission, after notice and opportunity to be heard. A generic review of NGDCs' supplier coordination tariffs can be undertaken as a formal investigation initiated by the Commission or by petition.

4. Impact on Effective Competition - The goal of suppliers in proposing measures to reform cash out rules in NGDC supplier coordination tariffs is to decrease operational costs. Reforming cash out rules and other rules related to the management of supplier gas on the NGDC systems should increase supplier participation in the retail natural gas market.

5. Disadvantages and Costs - A primary objective of cash out rules was to compensate SOLR customers for use of their gas supply assets to balance the system. The adoption of an alternative cash out benchmark may have implications for the settlement of the SOLR account.

M. Electronic Bulletin Boards (EBB) [10]

1. The Issue - EBBs are maintained by NGDCs and are accessed via a secure network/Internet connection by NGSs to post nominations and schedule deliveries of natural gas on the NGDCs system. Real time information is posted regarding the movement and delivery of natural gas supply movement on the NGDC system.

Although most NGDCs use a form of an EBB, there is little standardization of the format and operability. Some NGDCs augment the EBB with email, phone and fax support. It was noted by a large NGS that, for its multi-state operation, it must monitor 17 EBBs for activity of its customers and the interstate pipelines that serve the NGDCs. The lack of standard communication protocol and consistency for notices among the entities creates training issues and can lead to errors.

2. Positions of the Participants - NGSs propose that the following information (for all nominated volumes) and other features are essential in EBBs:

The volume, contract number, and pipeline, and a notation as to whether volumes are, or are not confirmed;

10 *See* footnote 9 above.

All alerts and other informational messages;
Imbalances and imbalance trades for NGSs to view their own positions and confirmed trades;
Nominating procedures and deadlines, as well as operational flow orders when called and rules NGSs must follow during those operational flow orders;
Entering information regarding nominations should be simple so that a NGS should be able to enter the contract number, pipeline and volume;
The EBB should be easily accessible and posted information should be in a format that can be downloaded into Microsoft Excel (preferred) or a text file for simple importation into internal NGS spreadsheets and billing files;
EBBs should be available daily for daily metered customers;
EBBs should accept and confirm any necessary nomination changes on weekends and during off hours;
EBBs should provide real time information posting as to confirm and cut volumes as well as the contract numbers and pipelines associated with these volumes to allow NGSs to make the necessary corrections. Without real-time information posting, NGSs are uncertain as to whether they need to check the EBB again, or if the confirmations they see are valid and reliable; and
Links to the NGDC's most current tariff available online and to other supplier rules or manuals by which NGSs must abide should be placed on the EBB.

As best practices for NGDC EBBs, the NGSs offered the following:
Nominations should be able to carry forward from day-to-day unless NGSs make changes;
When nominations are carried forward, EBB should allow changes to existing nomination information, rather than requiring entire entries to be deleted and new ones entered;
During off hours, EBBs would provide real-time information on contracts cut, and/or intraday nomination confirmations in order to allow NGSs to make further corrections if necessary;
Cash out rates from the prior month could be posted on the Web site to allow NGSs to easily calculate and verify cash out impacts;
Confirmations of nominations for each nomination cycle could be posted so that when intraday nominations are made, the NGS can view confirmed volumes by cycle to ensure the intra-day nomination was captured; and
One year's usage history of each NGS customer could be posted to allow accurate forecasting of usage based on prior patterns.

At present there is no requirement for a NGDC to use a EBB for its NGS interactions. NGDCs are generally averse to the requirement based upon cost, although no cost estimates were provided.

3. Requirements for Implementation - After notice and an opportunity to be heard, the Commission could direct that NGDCs implement and maintain EBBs to facilitate communications and interactions between suppliers and NGDCs. No change in legislation is necessary; rather, the requirement could be imposed as the result of a Commission investigation or through the rulemaking process. Cost issues could also be addressed in the same proceeding.

4. Impact on Effective Competition - According to suppliers, the use of EBBs will facilitate communications and will enhance interactions between NGDCs and suppliers in regard to the movement of natural gas supplies and delivery to customers allowing for growth of supplier market share. Standardization of EBB format, content, functionality and use may also reduce errors.

5. Disadvantages and Costs - Although EBBs may prove to be cost-effective in reducing errors, maintaining EBBs may be expensive. NGDCs would seek to recover costs through distribution rates. Also, the time lag in posting current information can be excessive so that the EBB can itself become a barrier to timely implementation of NGS-NGDC interactions.

N. Mandatory Capacity Assignment[11]

1. The Issue – The issue is whether existing capacity assignment mandates should be modified. Section 2208(d)(1) of the Public Utility Code provides the NGDC with the option to release, assign or otherwise transfer capacity or Pennsylvania supply in whole or in part on a nondiscriminatory basis to suppliers or industrial customers on its system. 66 Pa.C.S. § 2208 (d)(1). Section 2204(d)(4) requires a licensed supplier to accept such release, assignment or transfer of capacity. 66 Pa.C.S. § 2204(d)(4).

However, Section 2204(5) of the Public Utility Code provides NGSs with a mechanism to petition the Commission to avoid such mandatory capacity assignments. 66 Pa.C.S. § 2204(5)(ii). Also, Section 2204(e) of the Public Utility Code provides NGSs and others the opportunity, under certain circumstances, to renew expiring NGDC contracts or to provide alternative contracts to meet system requirements. 66 Pa.C.S. § 2204(e).

Before discussing capacity assignment, it is important to explain system asset management. First, each system has a certain amount of available storage and firm capacity. Some systems have actual on-system storage; others have no or a limited amount of on-system storage; and others may contract out the on-system or off-system storage to third party managers, which may include the firm upstream capacity contracts. With respect to firm customer delivery, NGDCs must make arrangements to ensure that firm customers have sufficient available assets to meet a peak day consumption requirement.

To achieve this result, a combination of on-system and off-system assets, including firm upstream capacity, off-system storage, and other assets agreements, is configured. NGDCs that have no available on-system storage may contract with a third party for storage or capacity assets on a firm basis. In that way, during heating periods and as otherwise needed, the stored gas assets will be available, thus eliminating the need to go into the market to procure more gas, or at least as much as may be needed to fulfill firm customer consumption needs. However, typically it is incumbent on the gas supplier to ensure that, through a combination of firm upstream

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11 *See* footnote 9 above.

capacity contracts and on or off system storage arrangements, 100 percent of supply to satisfy a peak day's need is available.

Under mandatory capacity assignment, when customers migrate to alternative suppliers, the natural gas assets need to "follow" the customer. An asset can follow a customer in various ways, either through an actual assignment of assets, creation of a paper assignment (which includes a combination of injection and withdrawal rights, balancing services and peak day deliverability) or a flat delivery system, where customers can take advantage of assets through a combination of flat deliveries and an allocation of upstream firm capacity.

The significant distinction between the actual assignment and the paper assignment, and/or flat delivery method is that, in the latter, the NGDC retains the possession and control of such assets. With such possession and control, the NGDC can derive additional benefits from such assets, often referred to as "off-system sales."

2. Positions of the Participants –Many NGSs view mandatory capacity assignment as a financial/operational constraint on their operations and as a barrier to market entry and participation. Without the burden of mandatory capacity assignment, a supplier has more discretion in choosing whether to accept the NGDC assignment of capacity for the duration and at the price offered, or to make other arrangements for sufficient capacity to serve its customers.

As the NGSs described the issue, capacity assignment, whether mandatory or not, turns on access to assets. According to NGSs, having system deliverable assets[12] is essential to creating a competitive retail market, since such assets provide a means to buffer price volatility and to reduce the need for peak day deliverability with off-system assets. Also, because much of the capacity to the various city gates in Pennsylvania is already under contract, they view access to capacity from the pipeline forward as equally critical. As such, each utility typically has a combination of on-system and upstream firm assets that permit it to fulfill firm customer needs throughout the heating season.

The theory advanced by the NGSs is that if systems are created that support this approach, it is equally as important to the development of a competitive market that the revenues generated from "off-system sales" are shared equally by and among all customers, regardless of whether they purchase natural gas supply from a marketer or the NGDC. Because assets including on-system and upstream assets, local production contracts, and other services exist only because of the customer, it is essential that the benefit of the asset should be the customer.

Individual NGDCs take different views of the need to retain 100 percent of the assets as customers migrate to be served by NGSs. However, in circumstances where assets or the benefit of those assets do not follow the customer, stranded costs are created. Further, if the assets are of a value that cannot be replaced in the market and if the asset or the benefit of the asset does not follow the customer, the NGDC can utilize the asset to generate revenue. The consequence is that the customer served by a supplier may not be able to find replacement capacity, or, if a person does, it may be through the competitive supplier at a duplicative cost. In addition, the

12 System deliverable assets include on-system or contract storage, firm no-notice capacity, propane services, other system deliverable assets or a combination of these assets.

revenue from those assets is not typically shared with customers who procure gas supply from marketers, although customer assets are being utilized to create such revenues. Accordingly, the goal with respect to capacity allocation should be to minimize stranded costs, permit the customer who purchases gas supply from a competitive supplier to receive the full benefit of the assets without increased costs and to ensure that no group of customers subsidizes another.

While mandatory assignment of capacity is viewed as a barrier by NGSs, the NGDCs generally view it as a means for assuring that they have the firm capacity needed to serve all SOLR customers. According to the NGDCs, there was an expectation that over time, as contracts for capacity were renewed, marketers would take over contracts for capacity that were once held by NGDCs. This has not happened. For that reason, some NGDCs continue to favor full access to and assignment of assets. It was also noted that actual capacity release is a function of interstate pipeline tariffs, governed by the Federal Energy Regulatory Commission.

NGDCs note that contrary to expectations when gas choice rules were implemented, NGSs serving choice customers appear to generally favor mandatory direct capacity assignment and have not availed themselves of the ability to petition to be relieved from such mandatory assignments. Choice NGSs have not offered through the collaborative process to renew or bring new gas supply assets to NGDC systems.

3. Requisites for Implementation - Because mandatory capacity assignment is statutorily based, the elimination of the requirement would involve a legislative amendment. However, Section 2204 (d) (5)(ii) authorizes the Commission, upon petition of the supplier, to prevent such capacity assignments under certain circumstances. These circumstances include, among others, when the Commission finds that the alternate capacity which the supplier seeks to utilize meets the NGDC's operational needs and reliability standards or when the Commission confirms that the NGDC's specific transportation and storage capacity contracts to be displaced are no longer needed to serve firm customers.

4. Impact on Effective Competition - Mandatory capacity assignment is a financial/operational constraint on supplier operations which the suppliers view as a barrier to market entry and participation. Removing this requirement would eliminate the need for the supplier to petition the Commission to use alternate interstate storage or transportation capacity to serve its customers. Without the burden of mandatory capacity assignment, a supplier would have more discretion in choosing whether to accept the NGDC assignment of capacity for the duration and at the price offered, or to make other arrangements for sufficient capacity to serve its customers.

5. Disadvantages and Costs – Some of the reasons that supported the mandatory capacity requirement in the original legislation still exist. Specifically, as NGDCs have noted, they continue to have the SOLR obligation and therefore need access to firm capacity, which would be a stranded cost in the event that the customers migrated to NGSs and the capacity did not follow them. In addressing this situation, it is important to consider system reliability and subsidization of NGDC supply customers.

O. Supplier Switching Timeframes (Slamming regulations)

1. The Issue - SEARCH members discussed switching timeframes in the context of the time it takes a new customer to start receiving service with a new supplier. These timeframes were established in the "Standards for Changing a Customer's Natural Gas Supplier" regulations (commonly referred to as the slamming rules) found at 52 Pa. Code §§59.91- 59.99. There are many different timeframes mentioned in the slamming regulations but the one that appears to be of most interest is the provision in Section 59.94:

> When a customer has provided the NGS with oral confirmation or written authorization to change NGSs, the NGDC shall make the change at the beginning of the first feasible billing period following the 10-day waiting period, as prescribed in § 59.93 (relating to customer contacts with NGSs).

2. Positions of the Participants – Many NGSs point to the "first feasible billing period" language as being too vague and providing too much discretion to utilities. As a result, timeframes vary from company to company, producing confusion and frustration for suppliers and consumers alike and additional cost for suppliers to comply with business rules which equate to barriers to entry. Switching timeframes and procedures can also usually be found in distribution company tariffs, although suppliers point out that this is not always the case and is not always uniformly presented.

NGSs insist that many customers express surprise and frustration with the delays that in turn lead to lost savings for the customer. A month or two month delay during the winter can be especially damaging. They do not understand why it takes so long to change supply services. This issue has also been the subject of some media attention.

NGSs contend that an analysis of supplier switching timeframes among different distribution companies demonstrates significant variations among NGDCs which seem to be correlated to the level of support the utility demonstrates for choice and competition generally. This variation makes it difficult for suppliers, especially ones operating in multiple utility service territories, to keep track of and inform customer accurately of switching timeframes. It is the collective experience of NGSs that enrollment timeframes that permit customers to begin with suppliers within a set number of days, or within one billing cycle, is a reasonable and practical expectation. Delays that are much longer than one billing cycle create confusion, reduce the benefits to consumers and frustrate the development of the market. Perhaps there are Information Technology (IT) changes that can be made that are not overly expensive. In addition, processes and procedures that do not involve IT issues could be examined and changed to speed up switching.

NGDCs contend that this is a consumer education issue. Customers need to be informed of the applicable timeframes upfront and have realistic expectations. However, as noted previously, the stakeholders agree that major new consumer education is not necessary at this time and future efforts should reflect the scale of changes that result from the SEARCH process.

NGDCs emphasize that this is not a simple matter and that the current rules and procedures strike a reasonable balance among concerns over consumer protections and administrative simplicity and are similar to rules found in other states with competitive gas markets. Many different factors (meter read dates, billing cycles, etc.) come into play and impact service start dates. Meter reading routes are established based on neighborhoods. Frequent deviations from these routes to accommodate special meter readings to initiate supplier service will necessitate the hiring of additional staff for this purpose. Mid-cycle changes may also make the customer bill for that month more confusing and more prone to dispute. Utility IT systems were set up a certain way and cannot be easily changed. IT changes, depending on just what is changed, can be expensive. Cost recovery will then be an issue. NGDCs contend that this is to a large extent a consumer education issue. Customers need to be informed of the applicable timeframes upfront as to avoid disappointment and lost savings.

Consumer representatives agree that, while uniformity in switching timeframes would be beneficial, they would not support measures to create uniformity that would require significant expenditures to be borne by ratepayers.

3. Requisites for Implementation – Changes could be accomplished by amending the regulation at §59.94 to mandate specific timeframes or time limits instead of "first feasible billing period" to address the problem. No party expressed much enthusiasm for a regulatory change. NGDCs are concerned that a set timeframe that would apply universally to all utilities is not realistic and would not take into account each utility's unique circumstances. Many NGSs also expressed skepticism that a regulatory change would necessarily improve the situation.

As an alternative to revising the regulation, the group discussed a collaborative approaching involving NGSs and NGDCs, which was generally supported. The collaborative would be part of a statewide process, but the solution(s) could still be company specific. The collaborative could operate without Commission intervention unless the process faltered and the parties then desired Commission involvement.

It is noted that NGDCs were required to set forth a process to establish a working group and a collaborative process in its restructuring proceeding. *See* 66 Pa.C.S. § 2204(f). The purpose of these working groups was to resolve operational and capacity issues relating to customer choice, reserving the final determination of operational and reliability issues to the NGDC. Also, NGDCs were to include in their restructuring filings a collaborative process to address broader issues relating to unbundling, customer choice and deregulation. Revival of these collaborative working groups could be accomplished by Commission order.

4. Impact on Effective Competition - The parties' perspectives differ somewhat on this issue. NGSs are in general agreement that this is a high priority issue because they believe it costs consumers money and is generally tarnishing the image of gas choice. It is also an issue that has received media attention. NGDCs generally believe that the importance of this issue is somewhat overstated and is to a large extent a consumer education/customer perception issue.

5. Disadvantages and Costs - A collaborative process would require time and attention of both suppliers and utilities, and consumer groups if they wish to participate. Direct Commission involvement may be needed to help facilitate if the process falters. Depending on what comes out of the collaborative, there may be costs associated with any needed information technology changes, which cannot be quantified at this time.

P. Service to Low-Income Consumers

1. The Issue - Barriers that prevent the participation of low-income customers in the competitive gas market and some possible solutions to help facilitate their participation were examined. One such barrier relates to the manner in which federal funds are administered in Pennsylvania by the Department of Public Welfare (DPW). Specifically, grants under the Low-Income Heating Energy Assistance Program (LIHEAP) go directly to the utility, who then credits the customer's account. For a company to be eligible for receiving a grant, they must be approved by DPW as a vendor. Under DPW's regulations, only those entities in control of a customer's heat can qualify as a vendor. Because suppliers do not physically terminate heating service, DPW has specifically excluded energy suppliers or generators from its definition of "vendor." *See* 55 Pa. Code § 601.3 – Vendor Definition in LIHEAP State Plan. NGSs note that other states, such as New York, do not have similar restrictions and aid is available regardless of from whom natural gas service is taken.

Some suppliers suggest that the purchase of supplier receivables by utilities might facilitate more low-income shopping. This could be coupled with allowing the utility to terminate service for unpaid supply charges and is addressed, starting on page 14.

The group also considered whether aggregating low-income consumers' load is an effective means to increase customer participation in the market. In Ohio, Columbia Gas and Dominion East Ohio aggregate the Percentage of Income Payment Plan (PIPP) customers and bid out their supply service. Columbia also was successful at doing this in Pennsylvania a few years ago, but in recent years has not been able to find any interested bidders. This is especially difficult if the bidders are required to price the supply under the utility's current price. Soliciting supplier participation in constructing any bid process to serve low income customers may increase the chances of obtaining bids. Also, even when aggregation of low income customers is successful, low income consumers gain no experience about participating in the retail market because pricing is transparent to the consumer.

2. Positions of the Participants - All parties are in agreement that facilitating the active participation of low income consumers is a difficult task that eludes quick or simple solutions. NGDCs have strong concerns with any purchase of receivables program (discussed elsewhere in this report). While not opposed to aggregation programs, they do question their efficacy, especially given the recent volatility of gas markets. NGSs also do not oppose aggregation programs, but some do question to what extent they can be considered part of the competitive gas market.

NGSs are more enthusiastic about the utility purchase of receivables. Many believe that, if structured correctly, this approach could facilitate low-income consumer shopping by removing bad debt risk from suppliers and continuing to place it with the party that has the ability to recover for that risk through its regulated rates and can terminate service. Suppliers also note that the threat of termination for nonpayment of supply charges may prompt the customer to pay or make payment agreements that will help them to avoid building arrearages.

Consumer representatives oppose any action that would potentially harm low-income consumers in the name of competitive choice. They believe that low-income consumers are extremely vulnerable and are in need of greater consumer protections, not less. In the view of consumer representatives, "solutions" such as allowing termination for supply services is an example of a "reform" that could actually cause low-income consumers more harm than gain. Other ideas, such as aggregation, which, in consumer representatives' view, does not negatively impact consumers and can improve the cost effectiveness of universal service programs, should be explored.

3. Requisites for Implementation - As to having NGSs declared as eligible to receive LIHEAP funds, this would require the Commission to approach DPW about changing its regulation, if it would be willing. Alternatively, this would have to be addressed legislatively.

The purchase of receivables would have to be done with the agreement of the utility or ordered by the Commission. If a bad debt tracker is used in conjunction with some sort of reconciliation mechanism as a means to increase low-income customer participation in the market, Section 1408 of Public Utility Code Section would need to be revised. *See* 66 Pa.C.S. § 1408 (relating to surcharges related to uncollectible expenses prohibited).

Aggregation of customers participating in universal service programs has already been done to a limited extent and no additional implementation steps would be required, unless it was decided to require such aggregation. However, suppliers believe that any aggregation program should be examined to determine if improvements can be made.

4. Impact on Effective Competition - NGSs contend that purchase of receivables could enhance options for low-income shoppers. Other parties believe that there is no single solution that will significantly impact the ability of low-income consumers to participate in the competitive gas market.

Some of the ideas discussed above may provide some incentive for more active participation, but all parties agree that expectations for this to happen are somewhat limited. NGSs believe this is especially true absent other reforms such as addressing default supply pricing. For example, aggregating universal service program customer load and bidding it out can produce savings that can reduce the shortfall (the difference between the customer's actual usage and what they are billed for) in order to minimize the impact of the program costs on the rate base. However, this assumes that a bidder is willing to bid below the utility's current price. Suppliers believe that if utility default supply pricing deviates too much from wholesale market prices, low-income consumers could end up in situations where they are paying more, even in an aggregation program, than they would be paying otherwise. NGSs believe that this argues for a more market-responsive default pricing mechanism.

5. Disadvantages and Costs - Some parties argue that ideas such as purchase of receivables could have significant costs and would be controversial. Other concepts, such as aggregation of universal service program customers, may save money if executed properly, and suppliers are willing to bid below the utility's current price.

Q. Seamless Moves (Customer Information regulations)

1. The Issue - Seamless moves, in the context of a customer physically moving from one address in a utility service territory to another address in the same territory and retaining his or her supply service, were also examined. NGSs believe it would facilitate competition to permit a customer to continue receiving service from an alternative supplier when they move within a service area. However, the current customer information regulations bar "seamless moves." *See* 52 Pa. Code §62.75. Under these regulations, when a customer moves from one location to another, even if the move is within a NGDC's service territory, the agreement is cancelled.

2. Positions of the Participants - Suppliers would like to have seamless moves. Some NGSs estimate that approximately 10 percent of their customer base moves each year, so it is a significant issue. Because of the inconvenience involved in re-establishing service with the same supplier at a new location, customers can become frustrated causing them to drop out of the market. Therefore, the lack of portability of a supplier service contract is a barrier to sustained residential customer participation in the market and is appropriately described as an obstacle to the development of the competitive retail gas market.

While not opposed to seamless moves, NGDCs have some concerns about possible IT issues involved with migrating consumers to new locations. Cost recovery of IT changes could be an issue. Even if a regulation change could be implemented; seamless moves would still not be universally available and would vary by supplier and by utility. For instance, the supplier may not serve some areas of the new service territory or service in the new location may be provided through a connection to a different pipeline system.

Consumer representatives agree that seamless moves would be useful but they would not support extraordinary measures that would require significant ratepayer expenditures to address the issue. They also expressed some concerns, mostly involving consumer consent to a seamless move. When the customer contacts the utility to move his or her utility service, a question arises as to whether the consumer should be asked whether the service from the NGS should also be moved. It is not clear how the matter would be handled if the customer does not want to continue receiving service from the NGS, or if the new location does not have gas service. Consumer representatives would want to ensure that the consumer is not subject to cancellation penalties if he or she did not want the supply service to be moved. Whereas consumer representatives are of the opinion that these issues need to be addressed at the time of the move, NGSs suggested that these contingencies can be addressed in the disclosure statements/contracts.

3. Requisites for Implementation - Section 62.75 of the regulations would have to be amended or waived. While amending the current regulation might be a lengthy process, any NGS interested in providing for seamless moves could petition the Commission for a temporary waiver of Section 62.75 and work with the NGDC on a solution. *See also* 52 Pa. Code § 5.43 (relating to petitions for issuance, amendment, repeal or waiver of Commission regulations).

4. Impact on Effective Competition - The parties agree that this change would not jump start competitive activity, but will become a larger issue if shopping activity picks up. Suppliers believe the lack of portability of supplier service is an inconvenience that discourages consumers from fully participating in the market and makes Pennsylvania a less likely market for suppliers to enter. They suggest, however, that, until other more fundamental issues such as default gas pricing are addressed, contract portability by itself will not help to energize the market.

5. Disadvantages and Costs - Amending Section 62.75 might be a lengthy process. Waivers of the section would be less time consuming, but are only temporary and would need to be renewed upon expiration. There may be IT costs incurred by NGDCs that would need to be recovered, and several issues raised by consumer representatives (discussed above) would have to be addressed.

R. Use of Marketer Referral Programs or Customer Assignment Programs to Facilitate Customer Participation

1. The Issue - Marketer Referral Programs are intended to facilitate customer participation in the competitive market by having the utility actively promote and implement the switching of customers to suppliers. There are several different marketer referral models and features, with the New York program operated by Orange & Rockland Utilities, Inc. (O&R) being the most prominent.

Under this model, consumers can contact the utility via telephone or Internet and can request to be referred to a specific marketer or to have the utility choose one for them. O&R uses almost all customer contacts to its call center to promote the program and encourages the use of alternative suppliers. Referral is made using a top of the queue method where the customer is referred to the next marketer at the top of the list. Customers who have participated in the program, or are with a current supplier, or have been with a supplier, are not eligible to participate. This rule results in the pool of eligible customers shrinking over time. In this way, the referral program may be self-limiting and may eventually reach a level of maturity where the program should be ended.

To participate in O&R's program, the marketer must agree to take all customers referred to it and must offer the customer a two-month introductory period with a set, guaranteed discount. The limited-time discount offered by the supplier acts as an inducement for customers to participate in the program and offsets the costs of customer acquisition for the supplier. After the introductory period, the supplier and customer agree to new terms, or the consumer can switch to another supplier or return to the utility. O&R purchases marketers' accounts receivable without recourse and handles customer account billing.

On December 22, 2005, the New York Public Service Commission (New York PSC) issued an order (Order Adopting ESCO Referral Programs Guidelines and Approving an ESCO

Referral Program Subject to Modifications, Case 05-M-0858 and 05-M-0332, December 22, 2005 (NY PCS Order)) that directed electric and gas utilities to collaborate with the parties to develop programs to facilitate the opening of competitive markets. The order included guidelines as to what appropriate elements should be included in any such program. This order may be accessed at PSC's website at http://www3.dps.state.ny.us/pscweb/WebFileRoom.nsf/ArticlesByCategory/A67D8868827812B4852570DF0050C25B/$File/05m0858_ordercomplete_12_22_05.pdf?OpenElement.

Customer Assignment Programs may involve the mandatory assignment of customers to a specific marketer. Such programs have been used as a method to increase customer and supplier participation in the market, and as a transitional device to complete a NGDC's exit from the merchant function. The number of NGDC's customers to be assigned to each marketer may be equally divided among all participating suppliers, may be determined by market share, or by some other arrangement.

2. Positions of the Participants – In general, NGSs favor the development of marketer referral programs as an effective method of opening up the competitive market for residential consumers since they are often hesitant to switch suppliers. According to NGSs, referral programs provide an easy risk-free method of sampling the competitive market, and the results in New York have been very positive with few complaints. This also addresses the issue of acquisition costs, which are identified by many suppliers as a barrier to residential and small commercial participation. At the same time, suppliers believe that participation in such programs by suppliers should be optional, and some stakeholders are of the view that a mandatory obligation to participate may be contrary to antitrust laws. In fact, some stakeholders have concerns that the programs, even if voluntary, may raise antitrust concerns that would need to be addressed.

Also in the interest of fairness, NGSs insist that customers be free to name the supplier they want. If a customer is not able or willing to name a specific supplier, the referral of the customer has to be done on a strictly random basis among participating suppliers. Some suppliers contend that a crucial element in these programs is the utility's purchase of receivables. Without this feature, there may be issues with credit worthiness and applicant screening. Alternatively, it should be considered whether suppliers would be expected to accept and serve all referrals. For example, if a marketer serves only commercial and industrial customers, the marketer should be permitted to accept referral of other commercial and industrial customers only.

Consumer stakeholders question how risk-free a customer referral to an alternate supplier is, especially after the introductory period. The introductory price could be seen as an artificial lure to consumers who may not understand the temporary nature of the discount. These programs can result in customers being switched with no idea as to what they will be charged after the first two months. A loss of customer confidence in competitive markets may result if customers are confused and end up paying more than they would have otherwise been paying had they remained with the utility. Also, consumers may find it difficult to navigate the system to return to NGDC service. Consumers note that there is nothing that prohibits a NGS from offering a discounted introductory rate to attract new customers; in other words, a marketer referral program is not necessary for a discount period to be offered. In addition, consumers see increased consumer education and protections as the more appropriate remedy to overcome residential customer hesitancy to shop.

NGDCs, while not dismissing the concept of marketer referral programs, do have some concerns with the implementation of such programs. These concerns are with cost recovery for the expense of altering information systems and staffing, since even small increases in average call time at a call center can accumulate to the point where additional staffing is needed. Any resulting deterioration in call center statistics could result in adverse reactions from regulators. Costs of these programs would also be imposed on all customers, even those electing not to choose. Some participation methods, such as the Internet, are less expensive than others but may not be accessible to all consumers and may not carry the same weight of a utility representative verbally recommending the referral program to customers as a way to try choice. NGDCs are also concerned that requiring a NGDC to make referrals to specific marketers may be wrongly interpreted by consumers as the NGDC endorsing a certain marketer over another or that the NGDC has a business relationship with a marketer.

Another general concern is that these programs should not be the result of blanket edicts that impose a uniform program on all utilities. The NGDCs prefer a more collaborative approach that would allow each company to design its own program. However, too much variation is a concern of suppliers and consumers in that it could cause customer confusion and complicate consumer education efforts.

Opinions vary as to whether consumer participation should be restricted to prevent "gaming," such as limiting consumers to one introductory offer per year. Consumers and some suppliers are not concerned about this possibility, while NGDCs are apprehensive about any expectations that they would enforce consumer restrictions, which they do not necessarily have the means to do.

The stakeholders are in general agreement that if the marketer referral programs are to be implemented, they should be evaluated at some future time to determine their effectiveness and to determine whether they should be continued. The stakeholders also agree that these programs should be limited to residential and small commercial customers.

In regard to the use of customer assignment programs to increase marketer and customer participation, lines were clearly drawn with minimal discussion of the requirements needed for implementation of such programs. Suppliers support the use of such programs to increase customer and marketer participation.

The OCA opposed customer assignment programs on the grounds that switching a customer's supplier without the customer's consent would violate Section 2206(b) of the Public Utility Code, 66 Pa.C.S. § 2206(b). This section states that a customer must provide "direct oral confirmation" or "written evidence" of his or her consent to change suppliers in order to be changed to a different supplier.

NGDCs contend that a NGDC should not be required to direct business to a supplier.

The only purpose of such a program is to force customer switching to a supplier, and to transfer the costs of customer acquisition from the suppliers to the NGDC and its customers, including those customers who wish to remain customers of the NGDC. To remove a NGDC from the merchant function may only serve to remove from the market the most competitive and least cost supply option for consumers. NGDC merchant function is expressly preserved under the terms of the Act.

3. Requisites for Implementation - The stakeholders could not agree as to the degree to which the Commission has the authority to order marketer referral programs similar to the New York model. NGSs generally believe that while there may not be express authorization in the statute, the Commission retains fairly broad authority to promote a competitive energy market. Most NGDCs and consumers believe that while the Commission could encourage and issue guidelines for these programs, its authority to order the implementation of such programs is questionable.

The stakeholders all agree that regulatory changes would be needed to make marketer referral programs possible. The current regulations, "Standards for Changing a Customer's Natural Gas Supplier" (commonly referred to as the slamming regulations), at 52 Pa. Code §§ 59.91- 59.99, specifically bars the distribution utility from changing a supplier without the customer first contacting a supplier and requesting service from the supplier. Customer information disclosure, 52 Pa. Code §§ 62.71 – 62.80, timeframes would also need to be examined and possibly revised.

There are also concerns with federal and state antitrust laws. Suppliers generally agree that these concerns are overstated and that similar concerns were raised in New York, and that the New York PSC ruled that the programs did not conflict with the federal Sherman Act or New York's antitrust provisions. *See* NY PSC Order, pages 49-57. The rationale of the New York PSC included the voluntary nature of supplier participation, that suppliers were still free to make offers outside the program and that the marketer referral programs were a state-sanctioned action intended to make the market more (not less) competitive. NGDCs and consumers generally agree that the Commission should consider and address the antitrust issues if these programs are to become a reality.

In regard solely to the issue of a customer's right to choose a supplier pursuant to 66 Pa.C.S. § 2206(b), a customer assignment program that requires a customer to agree to be assigned to an alternative supplier may be approved by Commission order. A customer assignment program that requires that a customer be assigned to a different supplier, absent the exit of the customer's NGDC from the merchant function or the appointment of an alternate supplier of last resort, would necessitate a revision to Section 2206 (b). Where mandatory customer assignment is necessary due to the NGDC exiting the merchant function, or the appointment of a supplier of last resort other than the NGDC, Commission slamming regulations at 52 Pa. Code §§ 62.71 – 62.80 may be waived temporarily.

4. Impact on Effective Competition – The objective of a customer assignment or a marketer referral program is to streamline the process of, and minimize the costs of acquiring customers for suppliers. A successful program should not only increase customer participation in the competitive market, but can also facilitate a NGDC's exit from the supply market. Besides providing a customer with a service discount for some set period of time, a marketer referral or a customer assignment program permits customers to experience the benefits of retail choice, to have direct contact with the supplier and to become accustomed to purchasing natural gas supply in a competitive retail market.

The New York PSC has described the O&R marketer referral program as one of the most successful strategies for encouraging residential customers to explore the benefits of retail access and reported a 37 percent migration rate of residential gas customers to alternative suppliers with only 1 percent of those participating returning to the utility. *See* NY PSC Order, pages 27-28.

It is noted that O&R's program has been promoted aggressively by the utility. The results of a less extensive program with more limited features are open to question. Consumer groups do not agree that the measure of success of a retail competition program is simply the number of customers switching to suppliers.

A customer assignment program was successfully employed in the Atlanta Gas Light market when the utility withdrew from the merchant function in 1998. The relatively small number of Atlanta Gas Light customers who had not chosen a marketer by a certain established date was assigned to a marketer based on then existing market shares. After some initial transitional issues were corrected, the assignment model worked well in establishing a competitive retail market in the Atlanta Gas Light service area.

5. Disadvantages and Costs - Costs would depend on the scale of the programs. A robust marketer referral program, such as the O&R model, where the utility is expected to use almost every customer contact to promote shopping, would probably result in increased staffing levels and training costs since even marginal increases in call handling times at a call center has a cumulative effect that requires additional staffing hours. There would also be the costs of information system changes and administrative costs related to processing customer switches. These costs would all be incurred by the NGDC and would presumably need to be recovered from customers. Ideally, some NGDC costs may be offset by a mutually agreeable financial arrangement between the supplier and the NGDC.

Although supplier failures have been rare, an intangible detriment might be loss of customer confidence if a supplier to which the customer has been referred or assigned failed to deliver supply in the quantity and/or at the price promised. Also, customers who have been assigned or referred to certain marketers may pay a higher price after the expiration of any initial price discount, again resulting in a loss of consumer confidence. Consumer confidence in assignment or referral programs may be promoted by permitting customers to return to the NGDC, if possible, or to switch to another supplier without penalty at anytime. However, permitting customers such freedom may result in costs to both suppliers and NGDCs.

S. NGDC Promotion of Competition

1. The Issue - At issue is whether to use incentives for NGDCs to promote competition and whether NGDCs should be prohibited from marketing SOLR service.

2. Position of the Participants - NGDCs indicated that they do not market SOLR service and do not engage in activities, such as advertising campaigns or other mass-market activities, promoting SOLR service. No evidence was presented by any participant that marketing activities for SOLR service are, in fact, occurring. It also was noted that the Commission's "Customer Information Disclosure" regulations at 52 Pa. Code §§62.71-62.80 govern NGDC communications with customers, including bill formats, and that NGDCs are subject to the Commission's "Standards of Conduct" regulations at 52 Pa. Code §62.141. These "Standards of Conduct" were adopted by the Commission in November 2005, after a public comment period.

Marketers and one industrial customer emphasized the need for clear rules and policies on this issue; sharing of best practices; enforcement of the Code of Conduct; effective customer education; and a supportive attitude and environment among NGDC employees with respect to the promotion of competition. Marketers further noted that NGDCs should, at a minimum, be indifferent as to who provides the commodity to customers and in a well-functioning market should actually encourage customers to consider competitive options absent some justifiable concern over reliability. Moreover, promoting competition by the NGDCs requires that they operate under the same rules and requirements under which NGSs must operate.

The promotion of competition requires that NGDCs foster an environment on their system where they work in collaboration with, rather than in competition with, the suppliers to improve service and options to customers. The marketers said the practice of NGDCs making their transportation program systems and services available to NGSs to operate has not and is not sufficient to promote competition. The marketers further claimed that the transportation program must be conducive to development of a competitive market, and the NGDCs' systems must be available, approachable and workable so as to create a level playing field.

One NGDC said that promotion should be driven not by policies but by the market and the options available in a competitive market. If customers remain with a NGDC, then that is a legitimate market outcome and should not be preempted by policies designed to promote one method of gas procurement over another through hidden subsidies, the removal of SOLR service pricing options or otherwise.

The NGDC added that they already promote competition by maintaining the systems and services necessary to enable suppliers to provide natural gas supply service to choice customers while maintaining reliability, and in facilitating customer understanding of their options. Further, the NGDCs should not be required to promote the product of a particular supplier, especially if the NGDC believes it is not in the best interest of the customers to do so.

NGSs contend that NGDCs should not be in the business of determining what may or may not be in the best interest of consumers, especially when they remain in the merchant function. One marketer said there is a clear distinction between actively marketing/promoting

NGDC default service and providing customers with pricing information and default service options in order to enable customers to choose a supplier.

Industrial customers believe that NGDC "promotion" of competition is critical to the maintenance and enhancement of markets. The role of the incumbent merchant is all important as markets grow and develop. Industrial customers said that the NGDC can be neutral, negative or positive with regard to market development, and it is hard for users, let alone marketers, to distinguish what role the utility is playing.

The stakeholders are in general agreement that a broad-based general awareness consumer education campaign is not needed, but that future efforts could involve existing resources such as the Internet, as well as community based organizations, to minimize costs.

3. Requisites for Implementation – Any promotional efforts or effective consumer education, ensuring that consumers throughout Pennsylvania are aware of their ability to purchase natural gas supply service from an entity other than the NGDC, can be conducted upon Commission order. No regulatory or statutory changes are needed.

4. Impact on Effective Competition – Generally, ensuring that consumers are aware of their ability to choose a NGS would promote the development of competition. Some marketers suggested that providing a NGDC incentive whereby a NGDC is paid a fee for each customer referred to a supplier can produce desirable cooperation and results in promoting retail competition.

5. Disadvantages and Costs – To the extent that costs are incurred by NGDCs or funds need to be collected to cover incentives that would be provided to NGDCs, consumers oppose recovery. OCA asserted that customers should not be responsible for providing the means for any cost recovery related to the use of financial incentives as a mechanism to advance NGDC involvement in the promotion of competition.

T. Sustained Commission Leadership in Competitive Markets

1. The Issue - This issue concerns the consolidation of a broad based group of activities and functions focusing on the promotion, facilitation, and stewardship of competition into a single organizational unit within the Commission. The best example of this is the New York PSC's Office of Retail Market Development (ORMD).

The New York PSC created the ORMD, the first organization of its kind in the country among utility regulatory commissions, in December 2003 to focus on electric and natural gas retail market issues and foster the development of competitive retail energy markets. ORMD is responsible for helping to create a level playing field for all market participants and ensuring that consumers have information needed to make informed choices when choosing an energy supplier.

New York's decision to establish ORMD has generated interest throughout the United States, Canada and United Kingdom. The Illinois Legislature has passed legislation to create a similar office[13] and the state Commissions of New Jersey,[14] and Texas[15] now have offices with a retail market focus within their agencies.

The New York ORMD had primary responsibility for:

- Market monitoring and utility migration reporting;
- EGS application and licensing;
- Uniform Business Practices (UBP);
- Electronic data interchange (EDI) standards;
- Power to Choose Web site and other competition related web content;
- Evaluation of utility retail access programs;
- Customer choice education and outreach;
- Market advocate;
- Implementation and drafting of Commission's policy statements relative to retail markets; and
- Informally mediate issues between and among utilities and marketers upon request.

The ORMD had 12 to 13 staff equivalents working to achieve its objectives. It used all available avenues to achieve its goals, including: mediation, rate case participation, customer education and marketing programs, etc. The ORMD worked on issues in the natural gas, electric and telecommunications industries.

However, the NY PSC closed the ORMD, on January 17, 2006. This change corresponds with a change in the Chairman of the New York PSC as well as in the management of the ORMD. Since its inception in December 2003, the ORMD enabled more than 100 suppliers to provide competitive savings to more than 1 million customers in New York. During its existence, the ORMD has helped the New York PSC to increase shopping among natural gas customers from 343, 000 to 454,000, a 32.2 percent increase. On the electric side, the ORMD helped the New York PSC to increase shopping levels from 375,000 to 739,000, a 97 percent increase.

2. Positions of the Participants – NGDCs opine that with respect to the topic of "Sustained Commission Leadership in Competitive Markets," initial discussions explored the concept of using a Phase-In Implementation Committee (PIC) (such as the Commission used for electric choice starting in the late 1990s), as well as establishing a competitive market oversight office such as the ORMD in New York. NGDCs further opine at this point, given the stage of market development, the specific barriers to market entry identified by the Commission in its Report to the General Assembly, and the ongoing collaborative process, neither a PIC nor an

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13 House Bill 4977, approved by both Houses on November 29, 2006, requires the Illinois Commerce Commission to establish an Office of Retail Market Development to promote retail electric competition for residential and small commercial electricity consumers. (*See* Illinois General Assembly - www.ilga.gov).

14 The New Jersey Board of Public Utilities, Division of Energy now has a Bureau of Market Development and System Reliability which oversees industry restructuring issues. (*See* BPU - www.state.nj.us/bpu/).

15 The Texas Public Utilities Commission has created a Retail Market Oversight office within its electric division. (*See* TX PUC - www.puc.state.tx.us/).

Office of Competitive Market Oversight (OCMO) within the Commission would be useful to promote the development of competition in the natural gas supply market for small customers (residential and/or commercial/industrial).

In the NGDC's view, the immediate task is to reach consensus, if possible, on specific and perceived market entry barriers as identified by the Commission. According to NGDCs the use of a PIC or OCMO would delay resolution of these issues. Moreover, unlike New York, Pennsylvania has enacted legislation which details the standards for restructuring the natural gas utility industry and the manner in which competition is to be implemented in the marketplace. The legislation mandates a mechanism for ongoing discussions between a natural gas distribution company, licensed natural gas suppliers having customers on the natural gas distribution company's system, and representatives of residential, commercial and industrial customer classes. 66 Pa.C.S. §2204(f).[16]

Rather than setting up new groups or creating new offices within the Commission, EAPA suggests that the stakeholders make better use of the existing process. EAPA is not aware of any of its members seeking to limit the participation of a supplier who does not yet have customers on a particular NGDC system in a Section 2204(f) working group or collaborative process.

In essence, EAPA's view is that a collaborative process already exists in the statute for stakeholders to resolve operational and capacity issues related to choice, 66 Pa.C.S. §2204(f)(ii), and to address broader issues relating to unbundling customer choice and deregulation. 66 Pa.C.S. §2204(f). A better use of this process should be the goal rather than forming a PIC or OCMO. It was also not clear on whose behalf an OCMO would be advocating or how a matter would be addressed if it could not be resolved at that level. The customer classes are already represented by OCA, OSBA and groups such as the Industrial Energy Consumers of Pennsylvania (IECPA).[17] NGDCs and NGSs are sophisticated business entities, regardless of their size, aptly represented both individually and through trade organizations. It is not necessary to establish a committee or office within the Commission to promote the interests of either of these groups.

The marketers fully agree with the NGDCs that full advantage should be taken of the working group collaborative process authorized pursuant to Section 2204(f) of the Public Utility Code. However, the NGSs note that Section 2204(f) can in practice prove to be cumbersome and has not provided a broad enough platform to resolve competitive issues. Ongoing regularly

[16] 2204(f) Working Group and collaborative process - In its restructuring proceeding, a natural gas distribution company shall set forth a process to establish a working group of licensed natural gas suppliers having customers on the gas distribution company's system and representatives of the residential, commercial and industrial customer classes to: (1) meet on a scheduled basis; and (2) seek resolution of operational and capacity issues related to customer choice. The final determination of operational and reliability issues resides with the natural gas distribution company. In addition, the natural gas distribution company shall include in its restructuring filing a collaborative process to address broader issues related to unbundling, customer choice and deregulation.

[17] Representatives of large customers note that their market is fully competitive. As such the market does not require the use of a PIC or other such organization and they oppose any measures that would allocate the costs of setting up an organizational unit to large customers.

scheduled meetings between each NGDC and the NGSs, whether serving on their specific system or not, to address issues and proposals for change of any party, similar to regular working groups of other states utilities, are viewed by NGSs as an excellent venue in which these two groups can collectively address how to maintain and foster competition.

NGSs believe that an OCMO could help motivate utilities to hold such meetings and implement changes to advance the development of retail markets. However, these groups will only be able to address issues specific to individual NGDCs. It is also important to address issues facing competition on a state-wide basis to ensure a reasonable level of continuity across the state as well as to allow parties to learn from experiences on other systems.

That is why the marketers support the institution of a statewide PIC-like process in which a broader group of market stakeholders can address issues facing competition. Contrary to the belief of the EAPA, marketers believe both of these groups are ways to collectively resolve both current and future specific and perceived barriers to entry or expansion in an amicable non-adversarial environment. It is unclear to the marketers how such a process where all stakeholders have an opportunity to address their concerns can be perceived as a hindrance to the process of ongoing identification and resolution of issues facing the Pennsylvania competitive natural gas market.

The positive experience recounted by those familiar with the PIC process would support its implementation as a means to resolve time-sensitive, issue-specific problems by the stakeholders in a manner that could save time and expenses associated with protracted litigation. However, in the event that consensus solutions cannot be achieved amongst the stakeholders, some marketers urge that the Commission permit stakeholders an adequate opportunity to present their viewpoints.

Some support a more formal creation of an OCMO so that it is not phased out and serves as an ongoing resource for all stakeholders, including NGDCs, NGSs, and consumers. If an OCMO would be created, marketers suggest that it could be charged with ensuring that whatever best practices, tariff changes and rule reforms that the Commission orders as a result of this proceeding are implemented in an expeditious manner. The OCMO would not serve as an advocate for any of these individual stakeholders, but rather as a check and balance that the actions of all of pertinent stakeholders conform to the Commission's interests of advancing the competitive market. In a broad sense, the OCMO would be a competitive market advocate.

As a competitive market advocate, the OCMO would be a main interface for competitive suppliers' inquiries regarding retail choice and would field concerns about choice program policies. The OCMO may also be responsible for monitoring the status of competition and providing periodic reports to the Commission about what had been achieved and offering recommendations for next steps as may be warranted. The important point is that the OCMO would be a consistent presence sending a clear signal to competitive suppliers and the consumers they serve of the Commission's commitment to competitive markets.

In the view of the NGSs, in order to ensure implementation of the results of this proceeding, the OCMO could monitor whether utility compliance filings are made, submit testimony as to whether the utilities filings accomplish the objective of the Commission policy, and make sure applicable deadlines are met. When participating in such proceedings to ensure the preservation and advancement of the competitive market, the OMCO could rely on assistance from the Commission's existing legal staff. Calling upon existing Commission staff to participate in proceedings for the purpose of advocating for the OCMO and the competitive market would not require additional resources from the Commission, but rather a re-alignment of roles in conformance with the Commission's objective of fostering competitive markets.

The NGSs believe that the pivotal distinction is that the role of New York PSC's ORMD is defined as a competitive market advocate within the Commission and actions taken are in accordance with that overarching principle. Marketers see a specific need for this in Pennsylvania and feel it can be achieved without raising issues of costs. As with the option of calling upon existing legal staff in addressing the overarching principle of the OCMO, there are ways to implement an OCMO by re-aligning resources. Additionally, the OCMO would not violate due process concerns because with any changes agreed upon there would have to be a filing made by the NGDCs. Each filing would provide an opportunity for interested parties to participate and provide their perspective.

Regardless of the exact structure, there is general support among marketers for a central point of contact who will facilitate all stakeholders' efforts and communicate with the Commission when concerns arise. Instituting a single office at the Commission would also promote coordination of Commission efforts related to retail choice.

An OCMO or similar structure is viewed by some marketers as essential if the Commission is going to develop sustained leadership with regard to competitive gas markets. The Pennsylvania equivalent of New York's ORMD could be the vehicle whereby the Commission changes its culture to accept that markets protect consumers better than does regulation.

3. Requisites for Implementation - The requisites for implementation of an OCMO would depend on its functions and the number of staff dedicated to support such functions. Absent an increase in complement, creation of this office would require the permanent or temporary assignment of staff to these functions. The OCMO can range from a single person acting as ombudsman for competition, a small work unit or a larger work unit, depending on the number and types of activities assigned. The OCMO's activities could range from minimalist (acting as a single point of contact for competitive related issues) to a fully staffed office taking on a full slate of activities and functions, akin to the former New York ORMD.

Implementation would likely require that the Commission consolidate some existing functions related to market activities that are currently being served in various Commission bureaus in the OCMO. Additional functions and activities necessary to safeguard and enhance competitive markets can also be assigned. Commensurate with those decisions, the Commission would need to direct that these functions be placed into a specific organizational unit within the Commission and decide on the staffing levels appropriate to carry out those functions.

Section 305(c) of the Public Utility Code authorizes the Commission to appoint, fix the compensation of, authorize or delegate such officers and employees as may be appropriate for the proper conduct of the work of the Commission. *See* 66 Pa.C.S. § 305 (c) (relating to director of operations, secretary, employees and consultants; employees and consultants). Section 308(f) of the Public Utility Code allows the Commission to establish any additional bureaus that the Commission finds necessary to protect the interests of the people of Pennsylvania. *See* 66 Pa.C.S. § 308(f) (relating to bureaus and offices; other bureaus and offices). Accordingly, the Commission may direct and assign current staff on a permanent or temporary basis to perform certain duties and functions related to market monitoring and facilitation.

It appears that the statute need not be amended to permit the Commission to establish and staffing an OCMO by the hiring of additional employees or by the assignment of current staff. Additional labor and employment issues that may result from the assignment, transfer and hiring of Commission personnel may be addressed through established Commonwealth Human Resource management directives, practices and policies.

4. Impact on Effective Competition - According to the EAPA, implementing, and funding an OCMO would have little to no impact on competition. Moreover, Pennsylvania's natural gas competition legislation mandates a mechanism for on-going discussions between a natural gas distribution company, licensed natural gas suppliers having customers on the natural gas distribution company's system, and representatives of residential, commercial and industrial customer classes. Rather than setting up new groups or creating new offices within the Commission, EAPA suggests that the stakeholders make better use of the existing process.

NGSs believe that a central point of contact will facilitate competitive suppliers' communications with the Commission when concerns arise. Instituting a single office in the Commission would also promote coordination of Commission efforts related to retail choice as well as in the development and implementation of a Retail Choice Policy Statement. Furthermore, the NGSs believe that an OCMO is essential if the Commission is going to develop sustained leadership with regard to competitive gas markets; a concerted effort by the Commission is needed to promote and facilitate competition. The Pennsylvania equivalent of New York's ORMD would be the vehicle whereby the Commission changes its culture to accept that markets protect consumers better than does regulation. The creation of OCMO will not only benefit existing stakeholders in the Pennsylvania natural gas market, but will send the message to potential market entrants that Pennsylvania supports the development of competitive market.

5. Disadvantages and Costs - Costs associated with this program would depend on the size of the unit. If a single person were dedicated as ombudsman, less cost would be incurred. If an entire organizational unit were dedicated, more costs may be incurred. However, in New York costs were minimized through allocation of existing resources. The level of costs would therefore depend on the Commission's decisions regarding which functions would be served by existing positions or whether creation of new positions would be required and ultimately the set up of the OCMO organizational unit.

U. Code of Conduct

1. The Issue - The Code of Conduct is contained in the Commission's regulations at 52 Pa. Code §§ 62.141-62.142. The Code of Conduct was adopted by Commission Order entered November 1, 2005, became effective April 14, 2006. It replaced similar rules that the Commission previously implemented as interim guidelines.

The Code of Conduct regulations govern the relationship between NGDC and affiliated and unaffiliated natural gas suppliers. The rules address the non-discriminatory application of NGDC tariffs in regard to scheduling, balancing, transportation, storage, curtailment, capacity release and assignment and non-delivery, etc. The rules have provisions for the non-discriminatory waiver of tariff provisions. The rules also address the processing of requests for: distribution services; the disclosure of proprietary information to affiliates; the separation of books, records, employees and offices; prohibitions on joint marketing; and dispute resolution.

Marketers have suggested that there is a lack of reporting, auditing or enforcement of the Code of Conduct, especially in regard to certain communications between a natural gas distribution company and its unregulated affiliates. NGDCs dispute this assertion.

Marketers have proposed changes to improve the reporting, auditing or enforcement of the Code of Conduct. First, it has been suggested that compliance with the Code of Conduct should be included as a specific item in audits mandated by Section 516 of the Public Utility Code, 66 Pa.C.S. § 516. Second, retail customers may require education about the Code of Conduct. How retail customers should be educated and who should educate retail customers are two critical questions that would have to be answered.

2. Position of the Participants - Marketers expressed support for the utilization of the existing regular management audits to ensure compliance with the Code of Conduct. Some other participants agreed that this issue should be included in management audits as an enforcement tool. While a few NGDCs expressed opposition to inclusion of the compliance item in management audits, one NGDC stated that the inclusion would be reasonable but superfluous. The NGDCs believe that the existing Code of Conduct regulations and Company tariffs are adequate and were established through a process that used input from all stakeholders that was duly considered by the Commission. Reference was made to the existing informal and formal dispute resolution procedures that are already available to adjudicate alleged NGDC violations of the Code of the Conduct. NGDCs pointed out that requiring an audit in addition to the formal and informal dispute resolution process would be uneconomical and a duplication of efforts.

Some marketers believe that consumers should be educated about the Code of Conduct, because consumers may in some instances be in the best position to identify that a violation of the Code of Conduct has occurred. They also maintain that all stakeholders should be involved in developing the education messages related to the Code of Conduct. They do not believe, however, that a full-fledged education campaign requiring significant funding is necessary, and favor an approach utilizing the Commission Web site as a more effective and less expensive means of educating customers on the Code of Conduct.

NGDCs individually and/or through their industry representative oppose customer education on the Code of Conduct. They believe it would be non-productive, create confusion, be difficult to explain and/or frustrate customer choice. Consistent with its position in the past, the OCA also does not see the need for an education program, finding it unnecessary and possibly leading to confusion and that further cost recovery from customers for such efforts should not be permitted. However, several other participants indicated that they had no problem with marketers providing consumer education on the Code of Conduct, with one of those parties stressing that NGDCs should not be required to provide funding for such education campaigns. If there is a Code of Conduct education effort, large customers state that no costs should be allocated to them, since large customers do not need any such education.

3. Requisites for Implementation - Changes to the Code of Conduct regulations would require the Commission to initiate a new rulemaking process. The review of a NGDC's relationship with affiliates has been included in management audits. Therefore, inclusion of Code of Conduct compliance, to the extent it is not already included in reviews of relationship with affiliates, as an item in management audits might require a change to the Commission's management audit process.

No particular action seems to be needed to permit marketers provide the education to customers on the Code of Conduct or for the Commission to highlight the Code of Conduct on its Web site. However, an education campaign, similar to those conducted to educate consumers about electric and natural gas competition, funded by customers, would require a Commission-led process to develop the educational materials, recommend funding sources, etc.

4. Impact on Effective Competition - NGSs believe that comprehensive enforcement of the Code of Conduct is essential to the development and sustainability of a competitive market. The NGDCs believe that Commission sponsored customer education on Code of Conduct would send a confusing message to customers to be wary of competition rather than promoting shopping and competitive choice.

5. Disadvantages and Costs – Including Code of Conduct compliance in management audits may cause some additional costs to be incurred, but they would likely not be significant. Funding for a consumer-education campaign on the obligations and duties of a NGDC under the Code of Conduct would result in rate increases for distribution service and for SOLR service (bundled supply and distribution service) offered by NGDCs. Based on the comments of the OCA, NGDCs and large customers, it is doubtful that a consumer-education campaign on NGDC Code of Conduct issues would result in increasing effective competition in the natural gas supply services market. However, marketers suggest that an education effort based on utilization of the Commission's Web site would be an inexpensive approach and would enhance competition. In general, stakeholders agree that a new comprehensive consumer education campaign is not necessary at this time and should not be relied on to stimulate competition, but rather be designed to reflect the market and changes made.

V. NGDC Negotiated Supply Contracts

1. The Issue - Several NGDCs offer negotiated supply contracts to larger customers. These programs take one of two forms. Either the NGDC offers an agency arrangement through which the NGDC will procure supply for the customer or the NGDC will directly offer negotiated supply rates.

Concerns have been expressed regarding the impact of such negotiated supply contracts on the competitive market. The question has been raised as to whether NGDC negotiated supply contracts implemented either directly or through an agent, are a barrier to competition. Some NGSs have recommended that NGDCs be prohibited from entering into negotiated supply contracts. To the extent a NGDC wishes to enter into such transactions, some participants state that it must do so through an unregulated supply affiliate, complying with appropriate Codes of Conduct.

2. Positions of the Participants - Most of the NGDCs commenting on the issue stated that negotiated supply contracts are necessary as part of an overall choice system for their customers. The NGDCs point out that they have no superior skills in obtaining upstream supply for customers. One NGDC suggested that these types of sales to large commercial and industrial customers constitute a very small portion of load. NGDCs contend that if a NGS is losing customers to a NGDC or cannot lure customers away, it is simply a function of the competitive market. NGDCs assert that their supply offers simply provide additional choice. The NGDCs also note that elimination of these negotiated supply contracts necessarily moves them out of at least a portion of their merchant function, a step the Commission and the General Assembly have not taken. Given the suggestion that this practice affects a small portion of load, the suggestion was made that the Commission should survey the extent of loads served under such contracts before taking any action.

Some non-NGDC participants suggest that NGDC negotiated supply contracts must continue for the short or interim term until the market matures sufficiently and customers gain confidence in the ability of the market to supply their needs. These stakeholders suggest that negotiated supply contracts are part of the over-all problem of reaching a market-state in which NGDCs will find it in their business interest to voluntarily exit the merchant function or significantly reduce that aspect of their business. Like the NGDCs, these participants do not support elimination of negotiated supply contracts by regulation or statute, but favor an over-arching approach to the market which will eventually eliminate these transactions simply because the market has reached a state where they are no longer viable.

NGSs oppose NGDC negotiated supply contracts in either form unless they are provided through a NGDC's affiliated NGS that is subject to the Code of Conduct. NGSs agree that if NGDC negotiated supply contracts were to be prohibited, existing contracts might need to be grandfathered and allowed to continue to the end of their existing terms. Some NGSs commented that grandfathering should be limited to the shorter of the end of the contract term (with no extensions) or one year. As to the agency type of program, most NGS commenters raise issues regarding customer confusion (the customer believes the NGDC is the supplier, not another entity), Code of Conduct problems (NGDC personnel interact with unregulated affiliate personnel to obtain account information, potential mixing of supply to provide better pricing for negotiated transactions than Section 1307(f) customers), and "level the playing field" arguments.

Some of the "level playing field" arguments include the ability of NGDC affiliates to reduce costs related to marketing and other customer acquisition costs due to their relationship with the NGDC. Similar issues are raised with respect to direct NGDC contracts including an inability to monitor market behavior to ensure that supply/customer contact issues are not present. Included in this concern is the possibility of the NGDC being provided a profit using its regulated assets in direct competition with NGSs who do not have access to ratepayer funds or guaranteed recovery of costs using the same assets for all services. NGSs observed that this is of particular concern in the absence of active compliance monitoring, particularly if a NGDC and its affiliate are not concerned about Code of Conduct compliance in the first instance. NGSs assert that the argument that negotiated supply contracts are necessary due to the state of the market is a circular one. Quite simply, the market will not mature and become robust so long as NGDCs are permitted to conduct bilateral supply negotiations either directly or through agency agreements.

The advantages of the NGDCs and their affiliates in these transactions are not due to any superior skill in obtaining upstream supply, rather the advantages stem from the incumbency of the NGDCs and their relationships with affiliated NGSs. These advantages cannot be replicated by unaffiliated NGSs regardless of skill or experience. In response, one NGDC observed that there have been no claims of Code of Conduct violations by NGDCs and their affiliates.

3. Requisites for Implementation - If the Commission were to determine that negotiated supply contracts act as barriers to a fully functioning competitive market, it is likely that a legislative change would be required. At present, Chapter 22 of the Public Utility Code does not require NGDCs to exit the merchant function. However, some NGSs argue that prohibition of negotiated contracts does not amount to exiting the merchant function. That theory asserts that elimination of negotiated transactions from NGDC tariffs is all that is necessary and can be accomplished through Commission review or NGDC filings.

Alternatively, the Commission may examine a robust Code of Conduct requirement that addresses issues regarding supply source, customer account information and similar issues which could serve to "level the playing field" while permitting NGDCs to continue these types of transactions. NGSs suggest that any rate discounts should apply to the distribution rate. This would support economic development; a reason often advanced for negotiated supply contracts. Most commenters agreed that in the event these types of transactions were to be eliminated, all existing agreements should be "grandfathered" in. Some NGSs suggest that any grandfathering should be limited to the shorter of the existing contract term or one year. Most commenters recommend permitting the existing contracts to run through their terms, with no extensions permitted.

4. Impact on Effective Competition - NGDCs and other commenters suggest that elimination of negotiated supply contracts would only serve to remove one element of choice without actually enhancing the market. Some other participants state that eventual elimination of these transactions is necessary, but not at this particular time. Once the market has moved further on the continuum to a more robust market, elimination of these transactions would enhance that market.

NGSs state that elimination of NGDC negotiated supply contracts is necessary to improve the existing market. These commenters assert that these types of transactions serve as barriers to entry, stifle opportunities of NGSs to compete, reduce the opportunities for choice and likely create increased costs for other consumers in the same market, given the lack of separation of assets. The NGSs also assert that a level playing field would be created if negotiated supply contracts were either eliminated or required to be provided by NGDCs' NGS affiliates in compliance with a robust Code of Conduct. Such a construct would benefit the market and expand customer choices, not diminish them.

5. Disadvantages and Costs - NGDCs warn that elimination of these types of transactions would reduce customer options in a market where such options are already few in number. As those options decrease, customers may be unable to secure supply at rates similar to those available under the current system. Given the nature of customers impacted (generally large commercial and industrial customers), there could be economic development consequences to the Commonwealth.

NGSs disagree with this assessment and argue that either elimination of these transactions, or if allowed, then permitted only through NGDCs' NGS affiliates, will spur the competitive market creating greater and more innovative options. The almost uniform support for grandfathering existing contracts may serve to reduce negative impacts, to the extent they exist, by providing customers and NGSs advance notice and time to negotiate replacement contracts.

W. Municipal Aggregation Programs

1. The Issue - In a municipal aggregation program, municipalities such as townships, cities and counties head aggregated buying groups on behalf of their citizens. The government aggregator chooses a supplier for all of the members of its group. The supplier would then purchase natural gas supply for the group. Municipal aggregation programs can either be voluntary where the customers elect to enroll in a municipal aggregation group, or mandatory where the customer is automatically enrolled in the program and must take some action to leave the program.

In Ohio, the Northeast Ohio Public Energy Council has been aggregating residential customers since March 2002, and consists of 128 communities in both the service territories of Dominion East Ohio and Columba Gas of Pennsylvania and represents 316,000 customers.

2. Position of the Participants - A few SEARCH members commented on this topic. One NGDC commented that the decision to participate must be a free choice for consumers. Some participants believe that an opt-out program could generate customer complaints and may not enhance the competitive market. One NGDC stated that an opt-out program is not true competition, but an artificial means to promote supplier entry into the marketplace. However, some suppliers contend that opt-out aggregation programs have helped to advance the competitive markets in Ohio.

The Industrial Energy Consumers of Pennsylvania (IECPA) opposed the use of any opt-out programs for large commercial and industrial customers. Many of these customers already have contracts for supply, and the opting-out process could affect these contracts to the detriment of customers.

One supplier expressed implied support for an opt-in municipal aggregation program, but then offered an auction-type program as an alternative. In this alternative proposal, the suppliers would bid for tranches[18] of retail customers, not wholesale load. The winning suppliers would end-up with a retail relationship with customers at a price that was competitively set through an auction process. A supplier's existing market share would affect the number of tranches for which it could bid.

An alternative aggregation model advocated by another supplier was a wholesale type auction similar to that recently established in Dominion East Ohio service territory. Under this model, suppliers bid for the right to provide supply to load which has not migrated from the NGDC and remains on the system as sales customers. This supplier suggested that this type of program has many benefits of other aggregation programs, and avoids several negatives identified by other market stakeholders. In contrast to most auction models, customers are not actually auctioned off for assignment to suppliers; the right to serve the load represented by a group of customers is auctioned off. Consequently, the right of an individual customer to choose a different supplier is not affected and the customer may in fact choose a preferred supplier at any time. The auction model transfers the obligation to provide natural gas supply to non-migrated customers from the NGDCs to the suppliers, but it does not disrupt the direct relationship between the NGDC and its customers.

As to the implementation of this load auction, the load represented by the non-migrated customers is divided into tranches of equal volume. Then the price and the number of tranches a supplier is willing to supply at that price are set through the auction. There is a limit placed on the number of tranches that any one supplier can serve so that market power cannot be gained as a result of the auction. The prices set by the auction are good for the term of the time period auctioned, and are based on NYMEX plus basis pricing (Standard Service Offer (SSO) Price). This means that the NYMEX piece is set for all bidders and that the basis piece is the portion bid on by suppliers. During each round of the auction, suppliers reduce the basis price they bid and indicate the number of tranches that they are willing to serve at that price until there are a matching number of suppliers and a matching number of tranches. This resulting price is reflective of the market price and enables customers to compare the SSO price to offers from suppliers in the competitive market.

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[18] Tranche is defined as "a division or portion of a pool or whole; an issue of bonds derived from a pooling of like obligations (as securitized mortgage debt) that is differentiated from other issues especially by maturity or rate of return." *See Merriam Webster On-Line Dictionary* at *http://www.m-w.com/cgi-bin/dictionary?va=tranche.*

Another aspect of this auction program is that NGDC storage and capacity assets tied to the load acquired are released to the successful bidders in the auction. The NGDC retains a small portion of the assets in their portfolios for the purpose of system needs and balancing.

One NGDC noted that marketers can already aggregate customer load and serve these loads through their service offerings.

3. Requisites for Implementation - In Pennsylvania, a municipal corporation is not required to be licensed as a NGS when it provides natural gas supply services to customers within its municipal boundaries. 66 Pa.C.S. § 2202 (relating to definition of natural gas supplier). However, it would be necessary to change the Public Utility Code to allow municipalities to provide natural gas supply service outside its municipal boundaries.

Pennsylvania municipalities include cities of the first class, second class, third class and fourth class, boroughs and townships of the first, second and the third class. Each municipality has been given express authority to provide certain service for its citizenry under the General Municipal Law at 53 Pa.C.S. §§ 101, *et seq.* and the specific municipal code for each municipality type. *See* 53 Pa.C.S. Part II (cities of the first class), Part III (cities of the second class); Part IV (cities of the second class A); Part V (cities of the third class); Part VI (boroughs); Part VII (incorporated towns); Part VIII (general township law); Part IX (townships of the first class); and Part X (townships of the second class). It is possible that legislation may need to be enacted to permit municipalities to provide aggregation service for their citizenry.

There would be no impediment to establishing an aggregation program with a voluntary enrollment feature. The Public Utility Code at Section 2206(b) provides that a customer must affirmatively choose to change suppliers. 66 Pa.C.S. § 2206(b).

Legislative changes would need to be made if participation in municipal aggregation programs was mandatory and customers had to affirmatively opt-out of the program. In the case of a mandatory enrollment municipal aggregation program, a user-friendly opt-out process would need to be established giving customers timely and sufficient notice of an opt-out deadline and a simple way to opt-out of the program, *i.e.*, a toll-free telephone number, a pre-addressed, pre-paid postage postcard, etc.

Implementing an auction of customer load may require a change in legislation since it would be inconsistent with current NGDC obligations relating to least cost procurement policies under Sections 1307(f), 1317 and 1318 of the Public Utility Code.

4. Impact on Effective Competition - A well-run municipal aggregation program could increase customer and marketer participation in the supply market and at the same time, decreases the role of the NGDC as a supplier of commodity. A municipal aggregation program not only can accustom the consumer to purchasing natural gas supply from an entity other than a NGDC, thereby promoting competition, but also can facilitate the exit of NGDCs from the merchant function.

Similar to the municipal aggregation programs, the Dominion East Ohio auction model decreases the role of the NGDC as a supplier of the commodity, and helps to familiarize consumers with the concept of commodity prices being set by market forces. This experience enables customers to respond to market price signals so they can better assess other competitive offers that are being made in the retail market.

It is noted that the competition that is initially by municipal aggregation and supply auction is competition in the wholesale, and not the retail market. However, as consumers become accustomed to purchasing supply from a non-NGDC source and NGDCs exit the merchant function, the stage is set for suppliers to follow through to make competitive offers to consumers so that a competitive natural gas service supply retail market can materialize.

5. Disadvantages and Costs - Costs of municipal aggregation programs will fall for the most part on the participating municipalities, or can be bundled into the cost of the supply. Aside from the commodity cost of natural gas, the majority of costs for the program itself would fall into two categories: administrative costs and consumer education. The goal of consumer education, besides explaining the program, would be to alleviate customer confusion and to overcome customer resistance to change. Some education and administrative costs for implementation of the programs may fall on NGDCs. According to the suppliers that advocated the Dominion East Ohio auction model, there were no costs or downsides except nominal administrative and filing costs.

NGDCs claim that exiting the merchant function may result in stranded costs relating to contracting supply and pipeline capacity and storage. Other costs may be political in nature and are entirely dependant on the success (or failure) of the municipal aggregation program. As such, these costs are not easily quantified.

X. NGDC Assessment Surcharge

1. The Issue - Changes in the regulatory landscape in Pennsylvania over the last 10 years warrant a review of the assessment process, which currently requires that all regulatory expenses allocated to the natural gas industry be imposed on natural gas distribution companies. One suggestion that has been offered is for natural gas suppliers to pay a portion of the regulatory expenses, which could possibly be based on some other factor, such as commodity distribution throughput, rather than on the basis of intrastate operating revenues. However, since the concept of assessing natural gas suppliers could introduce a barrier to competition, the working group considered another approach which would authorize NGDCs to use an automatic adjustment clause in recovering assessments from consumers. This mechanism would allow NGDCs to recover that cost outside of a base rate case, similar to the way state taxes are collected from consumers.

2. Positions of the Participants - NGDCs generally support this approach, and marketers are neutral as to this concept. They argued, however, against revisiting the issues relating to the assessment of natural gas suppliers. Consumers expressed serious concerns about any automatic pass-through of utility expenses.

3. Requisites for Implementation - An automatic pass-through of assessment expenses may require changes to Section 510 of the Public Utility Code, 66 Pa.C.S. §510, which sets forth the detailed formula and process followed for assessing regulated entities for the Commission's expenses. Also, the statutory provisions providing for assessments to cover the costs of the Office of Consumer Advocate (71 P.S. §309-4) and the Office of Small Business Advocate (73 P.S. §399.46) may also need to be amended. In addition, consideration would need to be given as to whether revisions of Section 1307 of the Public Utility Code, 66 Pa.C.S. § 1307, would be required.

4. Impact on Effective Competition - This measure would not promote competition, but would also not have any adverse effect on competition. However, it might make operational changes or other Commission activities designed to promote retail choice more palatable to NGDCs because of the increased certainty in their ability to recover regulatory assessments from consumers.

5. Disadvantages and Costs - The automatic pass-through of changes in regulatory assessment expenses by NGDCs would result in frequent (albeit relatively minor) rate adjustments for consumers. More importantly, it would mean that cost recovery would be permitted for this expense outside the context of a base rate case and without consideration of the companies' other revenues and expenses.

Y. Future Evaluation of Effective Competition

1. The Issue - A follow-up evaluation of whether effective competition exists in the natural gas supply market in Pennsylvania should be commenced two to five years after implementation of key measures resulting from this review. The particular timeframe may depend on the specific key measures identified by the Commission for immediate action, and how effective those particular steps are in promoting the development of effective competition. In providing for this look back, the Commission should identify which key measures need to be in place and for what length of time before the review commences. Alternatively, the Commission might choose to direct that the follow-up evaluation begin on a set number of years after its initial action resulting from this process.

The first step of the follow-up evaluation should be a reconvening of the stakeholders who participated in this review. The criteria for that evaluation should include the same as those considered by the Commission in the October 2005 Report to the General Assembly, including participation in the market by many buyers and sellers, the lack of substantial barriers to market entry for suppliers, the lack of substantial barriers that would discourage customer participation, and the presence of sellers offering buyers a variety of products and services.

This look back would be a more formal review and supplement any day-to-day competition monitoring that is being done by Commission staff. This evaluation would not need to revisit all issues currently under review by the Commission, and could entail minor adjustments or expediting the implementation of mid-term or long-term measures that are being identified during the pending review. The scope of that review is a decision that should be made at a later time after participants have some experience with changes that are made as part of this process.

The length of time between now and any follow-up evaluation would likely affect the significance of any changes contemplated at that time. For instance, a review that occurs after two years would likely look at less significant changes than one that occurs after five years. Also, minor but important adjustments would not necessarily need to await the follow-up review regardless of when it is conducted.

Within six months after reconvening the stakeholders for such an evaluation, stakeholders and staff should submit a report and recommendations to the Commission for further steps. Those recommendations might include implementation of mid-term or long-term measures that are being identified during the pending review.

Shortly following the conclusion of the pending review, a group within the Commission should be designated to address daily or ongoing issues that arise affecting the above-mentioned criteria. The input of this group should be considered by the stakeholders during the subsequent review.

2. Positions of the Participants - Most stakeholders support an ongoing monitoring of market development and a subsequent evaluation of the impact of any short-term changes on that market. Both tools would allow stakeholders and the Commission to ensure that adequate steps have been taken, discuss whether longer term measures should be employed, consider whether any unintended consequences have occurred as a result of those measures which have been implemented, and address all such issues as necessary and appropriate. While marketers generally support a two-year review, natural gas distribution companies favor a five-year review, especially if any fundamental changes are contemplated.

3. Requisites for Implementation - Commission directives to designate an internal group to monitor competitive developments and to later reconvene the stakeholders would be sufficient to implement this recommendation. No statutory amendments, regulations or tariffs would be required.

4. Impact on Effective Competition - This measure would have a moderate effect on the development of effective competition since it would give marketers a level of comfort that if the steps taken now are insufficient, a forum will be provided for implementing additional measures. It would also offer assurance that a process is in place to immediately address problems encountered in the market pending the subsequent evaluation.

5. Disadvantages and Costs - A downside or cost associated with this review would include a greater lack of certainty among stakeholders in the permanency of changes made to the market, which may result in a reluctance to make or respond to such changes. This more significantly impacts natural gas distribution companies who may make significant changes in their systems or operations, which then need to adjusted again in a relatively short time period. Also, this approach would require stakeholders to incur additional resources in connection with participation in a subsequent evaluation. It is noteworthy, however, that both the lack of certainty and the possibility of needing to later expend additional resources are present even without a planned further review.

Conclusion

The foregoing discussion represents the efforts of the participants in the natural gas industry in Pennsylvania, their customers and Commission staff to identify possible solutions to overcome obstacles that may have prevented the development of a robust retail market place for natural gas in the Commonwealth. Although other potential solutions could also be considered, the issues reviewed by the working group are extensive and offer ways to advance competition for natural gas in Pennsylvania.

PENNSYLVANIA PUBLIC UTILITY COMMISSION
COMMONWEALTH OF PENNSYLVANIA
HARRISBURG, PENNSYLVANIA

THE CHAIRMAN

June 26, 2009

The Honorable Arthur Coccodrilli
Chairman
Independent Regulatory Review Commission
14th Floor, Harristown II
333 Market Street
Harrisburg, PA 17101

Re: L-2008-2069114/57-269
Proposed Rulemaking
NGDCs and the Promotion of
Competitive Retail Markets
52 Pa. Code, Chapter 62

Dear Chairman Coccodrilli:

Enclosed please find one (1) copy of the proposed rulemaking and the Regulatory Analysis Form prepared in compliance with Executive Order 1996-1, "Regulatory Review and Promulgation." Pursuant to Section 5(a) of the Regulatory Review Act of June 30, 1989 (P.L. 73, No. 19) (71 P.S. §§745.1-745.15) the Commission is submitting today a copy of the proposed rulemaking and Regulatory Analysis Form to the Chairman of the House Committee on Consumer Affairs and to the Chairman of the Senate Committee on Consumer Protection and Professional Licensure.

The purpose of this rulemaking is to ensure that consumers of natural gas will be able to shop for gas that is marketed on a level playing field for all market participants. The contact person is Lawrence F. Barth, Law Bureau, (717) 772-8579.

The proposal has been deposited for publication with the Legislative Reference Bureau.

Very truly yours,

James H. Cawley

James H. Cawley
Chairman

Enclosures

cc: The Honorable Robert M. Tomlinson
The Honorable Lisa Boscola
The Honorable Robert Godshall
The Honorable Joseph Preston, Jr.
Legislative Affairs Director Perry
Chief Counsel Pankiw
Assistant Counsel Barth
Regulatory Coordinator DelBiondo
Judy Bailets, Governor's Policy Office

TRANSMITTAL SHEET FOR REGULATIONS SUBJECT TO THE REGULATORY REVIEW ACT

ID Number: L-2008-2069114/57-269

Subject: NGDCs and the Promotion of Competitive Retail Markets

Pennsylvania Public Utility Commission

TYPE OF REGULATION

X Proposed Regulation

___ Final Regulation with Notice of Proposed Rulemaking Omitted.

___ Final Regulation

___ 120-day Emergency Certification of the Attorney General

___ 120-day Emergency Certification of the Governor

FILING OF REPORT

Date	Signature	Designation
6/26/09	H Bauer	HOUSE COMMITTEE (Preston)
		Consumer Affairs
6-26-09	[illegible]	SENATE COMMITTEE (Tomlinson)
		Consumer Protection and Professional Licensure
6/26/09	Kathy Cooper	Independent Regulatory Review Commission
		Attorney General
		Legislative Reference Bureau