ALLEGHENY INSTITUTE

FOR PUBLIC POLICY

EXPANDING NATURAL GAS COMPETITION IN PENNSYLVANIA

A Staff Report from the
Allegheny Institute for Public Policy

Allegheny Institute Report #99-02
February 1999

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The Allegheny Institute for Public Policy
The Center for Competitive Markets

Expanding Natural Gas Competition in Pennsylvania
February, 1998

Key Findings and Recommendations.

- The federal government has substantially completed restructuring the interstate and wholesale natural gas industries. Many states are restructuring their retail natural gas industries.

- Pennsylvania, a national leader in restructuring the electric industry, has no coordinated state policy for restructuring the natural gas industry. Instead, individual natural gas utilities are inefficiently and inequitably restructuring themselves, without the guidance of public policies for genuine competition in the public interest.

- Only large industrial customers have the right to choose competitive gas supply. Virtually all industrial customers of regulated gas utilities do so, saving money on their bills, and avoiding payment of the 5% gross receipts tax on gas purchased from a utility.

- Residential and most commercial customers do not have the right to choose competitive gas supply. Instead, they must pay higher regulated rates and a 5% tax on their gas bill.

- In the absence of state policy, four major natural gas utilities have voluntarily adopted and expanded customer choice programs on their own. More than 225,000 customers now purchase natural gas from a competitive supplier under these programs. While the sponsoring utilities should be commended for moving forward, their programs are designed and implemented by the utilities, and are subject to little input and monitoring from customers, competitive suppliers or policymakers.

- Residential and commercial consumers in much of Pennsylvania, including Harrisburg, suburban Philadelphia, Philadelphia, Allentown, Scranton-Wilkes Barre, Lancaster and Reading have no choice but to purchase their natural gas from their monopoly utility at regulated rates.

- Natural gas utility customer choice programs are not governed by uniform or comprehensive rules or procedures to assure genuine competition or consumer protections. Pennsylvania does not know whether these programs serve the public interest or whether the public interest can be served better.

- Failure to adopt a state policy means that Pennsylvania has lost control of its gross receipts tax revenues that evaporate as utilities unilaterally expand customer choice programs.

- The gross receipts tax should not be an impediment to restructuring. It has been evaporating on its own due to state inaction. More than half of all natural gas customers in Pennsylvania already avoids the tax, only residential and smaller commercial customers pay the tax, and tax avoidance is accelerating as utilities expand customer choice unilaterally. With a large budget surplus, the Commonwealth to drop its assumption that the gross receipts tax on natural gas bills cannot be repealed.

- Recovery of stranded costs is not an impediment to restructuring. The stranded costs at issue are relatively small and can be substantially mitigated. The burden of any remaining net stranded costs can be recovered from consumers after customer choice has been implemented if utilities are willing to cap regulated rates.

- It is not difficult to identify and implement an appropriate new structure of the current gas utility monopolies. The current monopoly should unbundle its services and provide monopoly transportation service to all suppliers and customers without discrimination. All gas supply and other competitive services should be provided by licensed suppliers, including any affiliate supplier of the existing monopoly.

- The provision of service to customers not choosing a competitive supplier is not an impediment to restructuring. The PUC can easily appoint one or more competitive default suppliers. The monopoly utility can continue to provide supply service until competitive default suppliers are appointed.

- Consumer protections can be retained and applied evenly to all consumers.

I. Introduction.

The natural gas industry has been "restructured" and partially opened to "customer choice" through a series of regulatory and market developments over the last 20 years. Many segments of the natural gas industry are substantially "deregulated," although the process is not complete. In fact, few residential or smaller commercial customers are likely to recognize that such developments have occurred or fully participate in the potential benefits.

The Federal Energy Regulatory Commission ("FERC") has adopted a series of orders and policies that require the "unbundling" of interstate and wholesale natural gas pipeline services into separate transportation, merchant and related services. Prior to these regulatory changes, interstate pipelines could tie use of their pipeline to customers purchasing the natural gas supply from the pipeline company or an affiliate. Following the federal policy changes, customers became entitled to purchase natural gas directly from competitive suppliers and still use "transportation service" over the interstate pipelines to the "city gate." The "city gate" is the point of entry to the distribution facilities of the local natural gas company that operates a local distribution system. ("LDC").

The federal policy changes gave "customer choice" to the LDCs, as wholesale purchasers from the interstate pipelines. In addition, the federal policy changes gave customer choice to some large industrial customers that are able to take natural gas directly from the interstate pipelines.

Regulatory changes in Pennsylvania partially mirrored the federal changes, so that LDCs unbundled their services into separate transportation, merchant and related services. While federal regulatory changes permitted customers to take transportation service through the interstate pipelines, the regulatory changes in Pennsylvania permitted large industrial customers to transport natural gas from the city gate, through the local distribution system, to their point of use. With these changes, large industrial customers who required transportation of natural gas through a local distribution system could choose their supplier of services as well.

Virtually all large industrial gas consumers and many larger commercial gas consumers have taken advantage of transportation service during the last ten years, purchasing natural gas from a competitive supplier and using the LDC to distribute the natural gas to the point of use. Customers participating in the competitive natural gas market have achieved direct savings. In addition, Pennsylvania customers avoid a 5% gross receipts tax on their gas supply purchases because the tax is imposed only upon sales from public utilities.

At the present time, Pennsylvania permits a utility to restrict a customer's right to transport natural gas purchased from a competitive supplier to those customers whose individual load exceeds at least 5000 Mcf or exceeds that amount in an aggregated buyer's group with no more than 10 members. Since average residential customers use between 100 and 150 Mcf of natural gas annually, residential customers can be excluded from the competitive retail market entirely. Many commercial customers can be excluded as well.

Several gas utilities have voluntarily broken through the legal hurdle by offering customer choice in "pilot" programs that in some cases are now open to all customers. These programs do not merely expand the availability of tariffed "transportation" service. Rather these pilots are individual utility programs that in effect restructure the retail natural gas industry.

Thus, the restructuring of the natural gas industry in Pennsylvania is incomplete but is nevertheless moving forward as the former monopoly utilities deem appropriate, without input or oversight from policy, consumer, or supplier perspectives. The current status of customer choice in the natural gas industry in Pennsylvania raises several serious problems that are insupportable as a matter of public policy:

- The availability of tariffed "transportation service" is not the same as having a restructured retail natural gas industry. For example, regulation of transportation service tariffs has not addressed the obligation of LDCs to serve all customers in their service territory.

- Only larger customers have choice and the opportunity to obtain the benefits of customer choice. Residential and smaller commercial customers are entitled to the same choice and any bill savings that are available.

- In some parts of Pennsylvania, LDCs have voluntarily opened their markets to competition. Even if excellent, these pilot programs do not reflect any coherent public policy. They represent utility driven restructuring of the retail natural gas industry without substantial input or oversight from the legislative, regulatory, supplier or customer perspectives. For example, several programs in effect guarantee recovery of all stranded costs.

- Residential and smaller commercial customers in some parts of the state have choice while others do not.

- Customers buying natural gas from a regulated utility pay a 5% gross receipts tax on the cost of natural gas supply that customers purchasing natural gas from a competitive supplier avoid. With customer class and regional disparities in the ability of customers to purchase gas from a competitive supplier, the imbalanced tax treatment that results is unfair and cannot be justified as appropriate public policy. Governor Ridge recently called for repeal of this tax.

- Natural gas is the only fuel source subject to price regulation under existing law. There is no residential, commercial or industrial use for natural gas that cannot instead be served with an alternative fuel source. Alternatively, there are many end uses for which natural gas is an energy efficient and/or economic source. Regulatory and tax policy should not regulate the price or market for natural gas in a way that distorts the efficient allocation of natural gas as a fuel of choice.

Pennsylvania, a national leader in restructuring the electric industry, retains public policies from the 1980s that fail to bring customer choice to most residential and commercial natural gas customers. Pennsylvania can and must modernize its natural gas industry if it is to have a more equitable and efficient natural gas industry as expeditiously as possible. Efforts by the Pennsylvania Public Utility Commission to complete direct access to competitive suppliers of natural gas have been blocked. Thus far, the General Assembly of Pennsylvania has failed to adopt legislation to require completion of the restructuring of the natural gas industry, leaving residential and smaller commercial customers "out in the cold."

At this point in time, few argue that continuing monopoly regulation of the natural gas industry is desirable. Similarly, few argue that utilities should unilaterally restructure the industry without appropriate input from consumers, competitive suppliers or state policymakers. Yet, that is exactly what is occurring. Now is the time to complete the restructuring of the natural gas industry so that all customers, especially residential and smaller commercial customers, have a full opportunity to obtain the benefits of a competitive market and customer choice. All customers should have the right to purchase natural gas in a competitive market and to have a local distribution company transport the natural gas to the point of use.

There are no substantial issues making completion of the restructuring of the natural gas industry difficult. The task of unbundling retail gas service is not particularly complex or difficult. As described, the natural gas industry already has been unbundled substantially, even at the retail level. Moreover, Pennsylvania has opened the retail electric industry in Pennsylvania to competitive market forces and many states have opened the natural gas industry. While details may vary, the experience to date in the natural gas and electric industry makes the task of completing the introduction of customer choice to the natural gas industry achievable with relatively simple legislation directing the Pennsylvania Public Utility Commission ("PUC") to implement gas industry restructuring without delay.

In a fully restructured natural gas industry, customers will continue to receive delivery service from a local distribution company but will be able to buy gas supply from a competitive supplier. The competitive supplier will purchase natural gas, transport the gas to the local delivery utility, and arrange for supporting capacity services as needed to meet the requirements of its aggregated customers. One or more competitive default suppliers will be available to provide services to customers without competitive suppliers.

This Report summarizes the current status of competition in the natural gas industry in Pennsylvania and demonstrates how easy it can be to complete the restructuring of the industry if there is the will to do. Section II of this Report describes the federal and Pennsylvania developments that have created the partial state of the restructured natural gas industry as it exists to date. Section III describes current efforts to expand natural gas competition in Pennsylvania through utility "pilot" programs and why such pilots are not a viable alternative to a state restructuring policy. Lastly, Section IV recommends several simple proposals that should permit adoption of natural gas restructuring legislation in Pennsylvania without further delay.

II. The Development of Competition in the Natural Gas Industry.

Historically, the natural gas industry was structured with a regulated retail monopoly for a Local Distribution Company ("LDC") to acquire gas supply and deliver it over its distribution system to all customers using natural gas in a defined geographic service territory. Although the LDC did not produce natural gas in the same way that a local electric utility monopoly is a producer of generation, the LDC had a monopoly to be the purchasing agent for all gas users inside the city gate. The LDC purchased gas from the suppliers and interstate pipelines as necessary to meet the requirements of its distribution customers. The LDC sold retail natural gas supply and distribution service to retail users inside the city gate at prices and terms regulated by the Pennsylvania Public Utility Commission.

At the wholesale level, natural gas wellhead production, sales and interstate pipeline transportation was a substantially integrated industry that was regulated by the Federal Energy Regulatory Commission ("FERC").

The natural gas industry first opened to some competition in the late 1970's in response to natural gas supply shortages and extreme market volatility and price spikes. The federal Natural Gas Policy Act of 1978 ("NGPA") began the process of restructuring the natural gas industry. While the NGPA addressed many detailed issues beyond the scope of this Report, it was substantially a response to the shortages and price spikes that created reliability problems for many essential users of natural gas, more than it was a policy decision related to customer choice. However, the NGPA did begin the process of deregulating the wellhead price of natural gas and setting in motion a series of events that have in fact restructured the natural gas industry considerably.

Upon implementation of the federal Natural Gas Wellhead Deregulation Act (1989), the production and pricing of natural gas was substantially deregulated. Beginning in the late 1980's, and especially after adoption of the federal Energy Policy Act in 1992, FERC also adopted a series of orders, most notably Order 636 (1992), that unbundled the wholesale supply and transportation of natural gas. Interstate pipelines were required to exit the merchant function. Wholesale purchasers, such as LDCs, as well as individual customers that could take service directly from an interstate pipeline, Could now purchase commodity natural gas from competitive producers and merchants while using unbundled pipeline transportation service to deliver the natural gas to the city gate or point of use.

At the state level, the natural gas shortages and price spikes of the 1970's lead to regulatory changes as well. The LDC sometimes was not able to buy enough natural gas, even at very high prices, to serve all customer load. The largest industrial consumers of natural gas were permitted a "self-help" remedy to purchase natural gas on their own account. The LDC then would deliver the gas to the purchaser.

This new "transportation service" became an LDC service in which the natural gas owned by another party, such as a customer, is transported from the "city gate" to the customer's point of use. Transportation service initially was an emergency response that permitted some consumers considerable flexibility in responding to the "energy crisis" of the period.

The first transportation service had little to do with "customer choice" or a purposeful decision to open the market to competitive forces. Initially, transportation service was informal, without tariffs or other regulation. The "transportation service" solution relieved LDCs of the responsibility to purchase enough gas for its high volume customers, permitted industrial customers to maintain production and have greater control over prices, and enabled residential and other "essential services" customers to retain full service in the face of a volatile market with supply shortages.

Transportation service did provide opportunities to save in a competitive market that was not experiencing supply shortages, however. When transportation service first arose, LDCs often had long term supply contracts with integrated production, merchant and pipeline companies. Customers able to purchase only transportation service from the LDC and purchase supply directly could take advantage of market opportunities as they arose. Even industrial customers that could not take service directly from the interstate pipelines could now obtain transportation service inside the city gate from their LDC. Instead of arranging only bundled gas supply and pipeline transportation services, the customer could separately arrange for commodity purchases, storage and pipeline capacity as well as transportation service inside the city gate.

The Pennsylvania Public Utility Commission first began institutionalizing gas transportation service in 1986 with the adoption of regulations requiring LDCs to file gas transportation tariffs.[1] Even at this point in time, the adoption of transportation tariffs primarily focused on supply problems and bringing order to the existing random availability and terms for transportation service. For example, the objective was primarily to "afford customers flexibility in choosing the degree of supply risk they are willing to assume."[2] While such concerns inherently focused on reducing costs in the face of shortages and volatile prices, public policy was not focused directly on competition or customer choice as a way to reduce prices and improve and expand services in a restructured industry. Arguably, the formalization of transportation service through the adoption of tariffs did not reflect "deregulation" of the natural gas industry at all: regulation that had fallen by the wayside in response to emergency conditions was instead re-established.

For example, the regulations established cost of service and related principles for the pricing of tariffed transportation service. The regulations also required a transportation customer to sell their natural gas to the LDC to serve "priority" customers in the event of an emergency. The regulations concentrated on the requirements and terms for regulated transportation service from the monopoly LDC, not on changes in the LDC gas merchant function or on the structure of the supply market.

The regulations also gave the LDC considerable discretion in making transportation service available and did not afford all consumers the right to utilize transportation service:

> Sec. 60.3 Eligibility for natural gas transportation service.
>
> (a) Transportation service shall be provided without discrimination as to type and location of customer. A natural gas utility shall state in its tariff the minimum volume of transported natural gas that entitles a

[1] 52 Pa. Code Chapter 60, Natural Gas Transportation Service, adopted October 16, 1986.
[2] Section 60.2(1), as published in 17 Pennsylvania Bulletin 546, 560, January 31, 1987.

customer to transportation service. These volumes shall be set at a level that maximizes the number of customers that can receive transportation service while permitting the natural gas utility to effectively and efficiently manage its natural gas distribution system.

(b) The tariff shall permit individual customers or groups containing no more than three customers to be eligible for transportation service. Larger groups shall be permitted if the utility and the customers agree.[3]

Only the larger natural gas utilities regulated by the Commission were subject to these new regulations.[4] Under these regulations, many utilities established the participation threshold at 50,000 Mcf, thereby restricting access to transportation service to only the very largest industrial customers. These regulations reflected the policy emphasis of the time. Residential and other “essential needs” customers were to be protected from supply shortages, while industrial customers that were sophisticated enough to make their own decisions were to be permitted to save money while accepting lower reliability in the event of a supply shortage.

However, the floodgate of choice nevertheless was open, and more and more large customers exercised choice. In 1984, approximately 6.7% of natural gas throughput of regulated utilities utilized transportation service.[5] By 1994, approximately 36% of all regulated utility throughput utilized transportation service from the LDC. During this time period, industrial customer purchase of natural gas supply from the LDC dropped from about 39% of total volume sold in 1984 to only about 6% of total volume sold in 1994. In contrast, residential and commercial sales were virtually unchanged during this period.

By 1989, supply shortages had become less of a concern and the economic benefit of competitive natural gas commodity sales was apparent. The Commission began a rulemaking that initially proposed prohibiting a utility from adopting an eligibility threshold greater than 10,000 Mcf annual usage. The Commission proposal was later modified to eliminate any restriction on eligibility for transportation service. Largely in response to demand for access from industrial customers and school districts, as well as opposition to unrestricted access from the LDCs, the Commission adopted liberalized regulations in 1991.[6] Utilities were still permitted to establish a minimum volume of usage entitling a customer to transportation service, but the minimum volume could no longer be greater than 5000 Mcf annually, and customers could now join together in groups as large as ten to meet the minimum threshold.

The 1991 regulations remain in effect. At this point in time, PUC regulations still permit LDCs to restrict customer eligibility for natural gas transportation service.[7] The

[3] 52 Pa. Code Sec. 60.3, as published in 17 Pennsylvania Bulletin 546, 560, January 31, 1987.
[4] Class A and Class B utilities.
[5] Statistics from PaPUC Order in Docket No. L-00930084, adopted August 8, 1996.
[6] 21 Pennsylvania Bulletin 5818, December 21, 1991.
[7] 52 Pa. Code 60.3(a).

regulations require an LDC to establish a minimum volume to entitle a customer to transport natural gas. The minimum volume requirement adopted by a utility is to be designed to "maximize the number of customers that can receive transportation services while permitting the natural gas utility to effectively and efficiently manage its natural gas distribution system." The minimum volume requirement adopted by a utility may not be greater than 5000 Mcf annually. In addition, the utility must permit an aggregated group of no more than 10 customers to meet the 5000 Mcf annual threshold. Under the regulations, a utility may agree to allow a larger group to aggregate as well.

The first real effort to complete the opening of the retail natural gas industry in Pennsylvania to customer choice began in 1993. The Public Utility Commission began a rulemaking process designed to expand gas transportation service to all customers and otherwise update transportation service to match the developments in the industry. After a contentious process, the Public Utility Commission adopted final regulations in 1996.[8] Even at this late date, however, the regulations were designed to update and unbundle services to facilitate transportation service in a limited way. For example, the proposed regulations disclaimed any intent to restructure the industry more generally, such as by addressing changing duties of the LDC to serve retail customers. The 1996 rules adopted by the Commission never became effective. Instead, they were rejected by the Pennsylvania Independent Regulatory Review Commission (IRRC) out of concern that they imposed de facto customer choice without legislative authorization.[9]

III. The Pennsylvania Natural Gas Competition "Pilots" Are Not A Viable Alternative to A State Restructuring Policy.

With the legal and practical structure of the natural gas industry lagging behind the market, developments in other sectors of the natural gas industry, and developments in competing fuel industries, four Pennsylvania LDCs have replaced the vacuum in state policy with unilateral action. These utilities have established customer choice "pilots" that have been expanded to permit over one million residential and small commercial customers to choose a competitive natural gas supplier. More than 225,000 customers in fact purchase from a competitive supplier under these programs that certainly are "pilots" no longer. While these utilities should be commended for their response to state policy inaction, individual utility programs are not a viable alternative to state policy.

A. Equitable's "Intelligent Choice."

A brief history of the Equitable program illustrates in many ways the lack of comprehensive, coordinated natural gas competition in Pennsylvania. In February, 1997, Equitable first proposed the program that became the current "Intelligent Choice."

[8] Docket L-00930084/57-150, adopted August 8, 1996.
[9] IRRC is an independent commission charged with reviewing proposed regulations from state agencies in order to limit unnecessary regulation.

Equitable's proposal was very much a voluntary, unilateral action. Several consumer representatives, suppliers, and the City of Pittsburgh intervened in the PUC approval proceeding and developed a "United Intervenors Stipulation" that proposed a substantially rewritten program. All parties other than Equitable agreed to the alternative program. Equitable argued that the Commission could not change its voluntary proposal absent generally applicable regulations or procedure for natural gas customer choice.

The PUC adopted the Equitable proposal with some modifications proposed by the other parties. The Equitable "Intelligent Choice" Program has been available to all customers on a voluntary basis since May, 1998 and has about 42,000 participating customers. The program is not characterized as a "pilot," but is a set of tariffs that are generally available to qualified customers on a continuing basis, without enrollment periods or other limitations.

Equitable's program provides "delivery services" and "pooling services" to smaller residential and commercial customers on a firm basis. Equitable describes the "pooling" service as a customer aggregation service in which a marketer assumes responsibility for its customer's gas deliveries and consumption and aggregates nomination and balancing on the Equitable system. Equitable determines whether a marketer is qualified and creditworthy, and requires that a marketer have a minimum of 50 customers and 5000 Mcf annual load. Thus, Equitable retains a form of the current restrictive eligibility requirements for transportation service, although it is small suppliers rather than small customers that are excluded from the market. Recently, there were four suppliers participating in the program, including an Equitable affiliate.

Equitable requires participating suppliers to accept and pay for assignment of its pipeline, storage and related upstream capacity contracts. By doing so, Equitable avoids identification of stranded costs or imposition of such costs on Equitable. At the same time, however, mandatory assignment of capacity contracts precludes competition for these services and precludes customer savings on a portion of the gas supply function that is generally recognized as priced above the current market. Thus, in the Equitable program, only the commodity cost of gas is subject to competition.

In response to the arguments of the other parties, the Commission required that the mandatory assignment of capacity be phased out as existing contracts expire. As the existing pipeline contracts expire, capacity and storage services may be provided competitively by suppliers.

B. National Fuel Gas' "Energy Select."

NFG conducted a 2-year pilot from 1997-1999 in which all 19,300 customers in a defined geographic portion of the NFG service territory were required to participate. NFG did not provide bundled service, although an NFG affiliate did offer competitive unbundled service. NFG appointed another competitive supplier to be the default supplier for any customer not selecting a supplier directly.

The NFG role fundamentally was that of a "gatekeeper." NFG designed the program, allowing for some input from interested parties. NFG appointed the default supplier, and determined eligibility for competitive supplier participation, including creditworthiness. In order to participate, NFG required a supplier to have at least 500 customers or an aggregated load of at least 60,000 Mcf annually. NFG therefore retained a form of the regulatory participation rules that excluded smaller suppliers from the market while requiring all customers to participate in the market. Customers were required to sign-up during a defined enrollment period and were not permitted to change suppliers except during a sign-up period. NFG did not offer consolidated billing.

In order to participate, a supplier was required to accept assignment of upstream capacity contracts based upon an assumption that the winter would be 10% colder than the normal forecast. There are not provisions for any stranded cost recovery.[10]

Initially, four suppliers participated in the program, including an affiliate of NFG, although one did not meet the minimum load requirement and dropped out of the program. One supplier, a local fuel oil dealer, won approximately 66% of the customers, while the NFG affiliate served about 8% of the customers, the default supplier served about 19% of the customers, and the remaining supplier, a national energy company, served approximately 6% of the customers. Besides being well-known locally, the fuel oil dealer that dominated the market offered consumers a $50 rebate and guaranteed 10% savings (including GRT savings) that was clearly the best financial deal available. For all customers, the savings averaged about 1-3% in addition to the savings from not paying the 5% GRT.

Now, NFG has proposed to expand its "pilot" to its entire service territory with approximately 213,000 customers, with some program modifications. No customer will be required to change supplier as was the case in the prior pilot, because NFG will provide default service. The program will again have a limited enrollment season that will be from April to September, with no switching allowed during the heating season. NFG now proposes to require suppliers to bill through NFG. The minimum qualification for supplier participation will be reduced to 250 customers or 30,000 Mcf annually. Suppliers will be required to purchase storage and other upstream capacity from NFG or an NFG affiliate whether required by the supplier or not.

C. Columbia Gas of Pennsylvania's "Columbia Choice."

The Columbia customer choice program is now in its third year, with approximately 70% of customers (273,000) eligible to volunteer to participate. Participation remains restricted to customers in identified geographic service territories, although the service territories included have been expanded significantly each year and Columbia intends to open enrollment to all customers during 1999. The program has continuing open enrollment throughout the year.

[10] The relationship between mandatory capacity assignment and stranded costs is discussed in the following section.

Unlike Equitable and NFG, Columbia now provides participating suppliers with the option to purchase assigned contractual capacity from Columbia without requiring any supplier to accept a mandatory assignment from Columbia. Suppliers may provide their own capacity, making such services open to competition. Initially, Columbia had also required participating suppliers to accept a mandatory assignment of capacity.

Columbia now imposes a 3 cents/Mcf surcharge on all customers, not just participating customers, to pay for unassigned capacity costs and a consumer education program. During the prior phase of its program, the Columbia surcharge was 1.5 cents/Mcf.

Columbia accepted some input from interested parties, but primarily designed the program, including its terms, rules and protocols. Columbia requires a supplier contract and reserves the right to impose penalties on suppliers. Columbia will now charge participating suppliers a fee for billing, bulletin board access, changing billing rates and similar functions. Columbia imposes a penalty for underdeliveries as well as for other violations of its program rules.

At last count, approximately 12 suppliers were participating in the program. Customers average savings up to about 3% in addition to avoidance of the 5% gross receipts tax. Columbia is emphasizing the opportunity to avoid payment of GRT and the availability of fixed rates and sign-up bonuses, as well as the opportunity to save on the cost of gas.

D. Peoples Natural Gas "Energy Choice."

The Peoples program is not characterized as a pilot, but as an implementation of its transportation service tariff without any minimum customer size to qualify for service. Participation has been open to all customers since April, 1996. Since it is characterized as implementation of an existing tariff, the Peoples program has not been submitted to the PUC for approval.[11]

There presently are five suppliers participating, one of which is the Peoples competitive marketing affiliate. One supplier has almost 80% of the competitive market share, and a second supplier has about 19% of the competitive market share. The remaining three suppliers together serve about 1% of the competitive market. Almost 120,000 of Peoples' 320,000 residential customers receive service from a competitive supplier.

Under the Peoples program, the participating supplier provides upstream capacity and all services necessary to serve load, although Peoples does require suppliers to accept a mandatory assignment of pipeline, storage and related contract capacity from Peoples. Peoples balances usage and deliveries on a daily basis. Peoples indicates that it has no

[11] In contrast, there are PUC orders authorizing Columbia, NFG and Equitable to implement their pilot proposals.

stranded costs as a result of its expanded transportation service with mandatory assignment of capacity contracts.

E. Gas Competition through Utility Pilots is Not a Viable Policy Option.

Clearly, the Pennsylvania utility "pilot" programs are expanding customer choice to an increasing number of customers in Pennsylvania, including residential and small commercial customers which previously were left out in the cold. Those utilities that are stepping up to fill the vacuum in state policy concerning customer choice in the natural gas industry deserve recognition. Even the best of these pilots, however, cannot be considered an alternative to a coherent statewide policy concerning retail customer choice in the natural gas industry. The present state of competition in the retail natural gas industry in Pennsylvania, led by individual regulated utilities and driven by the incentive to avoid taxes imposed by the General Assembly, illustrates the vacuum in public policy that exists. When utilities implement their own customer choice programs, policymakers, customers and suppliers cannot expect that the programs will necessarily serve their interests or address their concerns.

The existing state of uncoordinated semi-competition is insupportable as a matter of public policy.

First, the Pennsylvania pilots remain insufficient in scale. LDC's are opening the programs to an increasing number of participants, but participation includes a small percentage of Pennsylvania's natural gas retail customers, even in those territories most open to customer choice.

Second, residential and commercial customers in major population centers, including Philadelphia (served by Philadelphia Gas Works), suburban Philadelphia (served by PECO Energy), Harrisburg, Allentown, Reading and Lancaster (served by UGI), and Scranton-Wilkes-Barre (served by PG Energy) have no opportunity to participate in these programs at all. The utilities serving these areas, for whatever reason, have not determined that it is appropriate or necessary to initiate customer choice programs that are open to residential and commercial customers. Utilities that have not voluntarily expanded customer choice retain a monopoly to sell supply gas supply services to residential and commercial customers in their service territory even though a competitive gas supply market exists elsewhere.

Third, the pilots are insufficient in scope. While there are some variations, all of the utilities operating pilots have retained their monopoly over some services that could be competitive. For example, pipeline capacity, storage, metering and billing can and should be subject to competitive market forces. Opening these non-natural monopoly services to genuine competition will permit service improvements, new products, and lower prices. Opening these services to competition will also entice a larger number of competitors into the market, permitting greater competition and competitive benefits even in those services, such as commodity gas supply, that are open to competition.

Fourth, most of the programs have few participating competitive suppliers. In several programs, the unregulated competitive marketing affiliate of the LDC plays a major or dominant role. In each program, there is no state licensing. Instead, the former utility determines whether a competitor is qualified to compete in the service territory. Allowing unilateral utility decisions to convert regulation of monopoly gas supply service to unregulated service is hardly the best way to assure the development of a genuinely competitive market in the public interest. The programs provide little, if any, opportunity to assure that genuine competition can develop with an equal opportunity for all competitive suppliers.

Fifth, the PUC has adopted a "Policy Statement" concerning the relationships between regulated utilities and affiliated competitive marketers.[12] While this Policy Statement provides a strong "shot across the bow" expectation of non-discriminatory behavior and no cross-subsidization, it is neither complete nor specifically enforceable. It exists in a regulatory structure that acknowledges that retail gas competition does not formally exist in Pennsylvania, while some utilities nevertheless reduce their regulated gas sales and increase their unregulated gas sales.

Sixth, there is no reason to believe that continuation of the existing "pilots" provide meaningful incremental understanding of customer choice to justify continued experimentation. Certainly Equitable, Peoples and NFG, opening their programs to all customers, and Columbia, opening its program to 70% of its customers, no longer believe such a reason exists.

Seventh, none of the pilots reflects a genuine competitive market nor provides a basis for sound statewide public policy decisions. Each pilot was designed by the utility, operated under utility control, and may or may not consider important consumer, supplier or public interests or concerns. Each program may or may not provide a meaningful opportunity for consumers or suppliers to participate or achieve the benefits of a genuinely competitive market.

Eighth, without publicly determined rules and policies, consumers may be rightfully concerned or confused about basic consumer protections. For example, the PUC adopted a Tentative Order declaring that shopping customers in the natural gas customer choice pilots must be afforded the same consumer protections as those continuing to purchase gas from the regulated utilities.[13]

Ninth, without publicly determined rules and policies, procedures and protocols may be completely different among service territories. Even assuming that each utility's set of rules accomplish the intended tasks, it is inefficient and anti-competitive to require suppliers to operate under different rules in each service territory.

[12] 27 Pa. Bulletin 4102, August 16, 1997.
[13] Obligations of Gas Suppliers to Comply with Chapter 56 Provisions, adopted at Public Meeting November 19, 1998. The Tentative Order may become final or be revised following consideration of comments filed by interested parties.

Tenth, even if the pilots had been designed and implemented with appropriate input from the PUC, suppliers and customers, none of the pilots have been subjected to any formal monitoring or independent evaluation to date. The utilities must be at least informally evaluating their programs, as rules changes have been proposed from year to year. While some utilities make presentations to the PUC from time to time, no evaluations or formal complete reports have been provided. Any information that exists concerning the pilots is information from the sponsoring utility or through an informal set of observations by various interested individuals. The PUC does not have basic information on the status or performance of the pilot programs.

At this point in time, there is no public policy reason to restrict customer choice in the natural gas industry. In contrast, rational public policy requires comparable treatment for utilities, suppliers and customers in different parts of the Commonwealth. Ultimately, the pilots must be viewed merely as something that exists in a vacuum of state policy on retail natural gas competition because the sponsoring utilities have deemed it within their interests to propose and implement the pilots as they have done.

IV. Recommendations.

The existing state of the semi-restructured retail gas industry violates basic principles of public policy without offsetting benefits. Customer classes and customers in different service territories are treated and taxed differently. Utilities and suppliers do not operate under the same set of rules within a service territory or across regions of the state. It would be difficult to design a less rational system of regulating the retail natural gas industry than the one that presently exists in Pennsylvania.

Pennsylvania must adopt gas restructuring policies intended to serve the public interest in Pennsylvania. Pennsylvania must accept that the failure to adopt restructuring policies will not stop the restructuring that nevertheless is well on its way.

In early 1997, Representative Frank Tulli, Jr., who previously had introduced the bill that became the basis for the Electricity Generation Customer Choice and Competition Act adopted in November, 1996, introduced House Bill 1068 to adopt a similar restructuring plan for the natural gas industry. In addition, Senator Piccola introduced Senate Bill 943 in May, 1997. Both bills were introduced with the goal of extending customer choice to all natural gas consumers and adopting a comprehensive approach to the restructured industry for the first time. Although the bills were considered in committee with proposed amendments and the participation of interested parties, they were never brought to a vote.

The bills and the underlying issues were instead referred by Governor Ridge to a “stakeholder” process similar to the process that resulted in passage of the Electric Generation Customer Choice and Competition Act in November, 1996. Numerous parties participated in a series of meetings that failed to result in “consensus” legislation, and the process was suspended in May, 1998. Finally, in January, 1999, Governor Ridge announced that he would seek repeal of the gross receipt tax on natural gas, and Chairman Quain has called on participants in the suspended "stakeholder" process to reconvene. At the present time, it is not clear whether these steps will result in the necessary legislative or PUC action to complete the restructuring of the natural gas industry with customer choice for all customers, including residential and small commercial customers.

Fortunately, there are no significant issues impeding the adoption of legislation to restructure the natural gas industry with customer choice for all customers. Most detailed matters have already been resolved in the electric industry, the wholesale natural gas industry, or the retail natural gas industry in other states. There is no need to reinvent the wheel. The legislation should provide clear but relatively broad guidance to the PUC to implement natural gas restructuring expeditiously.

The remainder of this Report addresses the relatively few policy issues that need to be resolved through legislation.

A. The Pennsylvania Gross Receipts Tax.

There is no reason for the Pennsylvania Gross Receipts Tax (GRT) to impede legislation to restructure the natural gas industry in Pennsylvania. The tax is inequitable and inefficient, and has been evaporating under the present state of customer choice in the natural gas industry. Certainly, the GRT on natural gas utility bills should be repealed, as Governor Ridge proposed in January, 1999. Hopefully, the GRT will no longer be permitted to prevent restructuring the natural gas industry in Pennsylvania.

The GRT is a 5% tax imposed on all natural gas utility bills, presently raising approximately $80 million annually from natural gas utility customers. The GRT has long been a political football because it is not imposed in a balanced manner. The GRT is only 4.4% on electric bills. Other non-utility competitive fuels, such as heating oil, propane and other deliverable fuels, are not subject to the GRT at all. Thus, the GRT is inefficient to the extent that it distorts customer choice of fuel.[14]

The imbalance of the GRT is also inequitable in the way it is imposed on different customers. Besides being an inequitable tax based upon the customer's fuel, customers of municipal utilities, such as the Philadelphia Gas Works, the largest LDC in Pennsylvania, do not pay any GRT.[15] Under the present state of customer choice in the industry, the GRT is regressively collected from smaller residential and commercial customers who are restricted from choosing a competitive supplier, while the large consumers face no such restrictions and easily avoid the tax.

[14] While public policy may prefer the use of natural gas to these other fuels in some situations for economic, environmental or other reasons, this aspect of tax policy discourages the use of natural gas.

[15] The GRT also misdirects other public policy considerations. For example, the public policy decision to operate the Philadelphia Gas Works privately has been raised from time to time. The assumption that such a decision would subject city residents and businesses to the 5% GRT distorts the discussion of whether such reorganization is good public policy.

As gas transportation service expanded in the 1980's, the large industrial customers escaped payment of the GRT on gas commodity purchases from an entity other than a public utility. In 1991, the Pennsylvania Commonwealth Court ruled that the Gross Receipts Tax applied to all sales of natural gas, whether from a public utility or not. Hanley and Bird v. Commonwealth of Pennsylvania, 590 A.2d 1382 (1991). Within three months, the General Assembly adopted legislation limiting imposition of the gross receipts tax to "gas companies whose rates and conditions of service are regulated by the Pennsylvania Public Utility Commission." 72 P.S. Sec. 8104 (P.L. 97, No. 22 Sec.29).

Thus, virtually all large industrial customers bypass GRT payment by diverting gas purchases to non-utilities. A customer purchasing natural gas from a competitive supplier pays no GRT on the commodity cost, while a utility customer continues to pay a 5% tax. Since industrial customers use more than one-third of the gas distributed through regulated utilities, the virtually universal exercise by large industrial customers of their right to purchase natural gas from a competitive supplier means that Pennsylvania revenue from the GRT has already atrophied by about one-third.

In the pilot programs, residential and commercial consumers are increasingly gaining access to non-utility supply. Commonwealth revenues from the GRT on natural gas sales are unstable at best and trending towards elimination based on the individual decisions of gas utilities and their customers.

In the natural gas legislation debates since 1997, the assumption that the Commonwealth must continue to retain the GRT has imposed a barrier to legislation. Industrial customers certainly were not going to agree to accept a 5% tax that they had escaped. Residential and commercial customers were not going to agree to pay the tax that industrial customers are permitted to avoid.

In January 1999, Governor Ridge announced that he would seek repeal of the GRT on natural gas sales. With the Commonwealth experiencing a significant budget surplus and GRT revenues declining through utility and consumer decisions, repeal precludes further delay in restructuring the natural gas industry based upon the GRT.

B. Stranded Costs and Transition Charges.

Similarly, there is no reason for stranded cost recovery to be a significant issue in natural gas restructuring. Stranded cost concerns cannot be permitted to be an impediment to adoption of policy. "Stranded costs" reflect the expenses already incurred by the utilities under regulation that will not be recoverable through regulated rates if customers are permitted to purchase gas from competitive suppliers. These costs are relatively small in the natural gas industry, can and must be substantially mitigated, and remaining net stranded costs should be recoverable after the fact.

A brief description of stranded costs in the natural gas industry reveals why they are not exorbitant and why they cannot be allowed to be a controversial issue in restructuring deliberations.

Under traditional regulation, gas costs are passed through to consumers on a cost basis. While a utility may not have had a strong enough incentive to minimize gas costs, as technically required by law, the utilities did not have any incentive to maximize gas costs either. Unlike the electric industry, the natural gas industry does not have a large capital investment in gas production that earns a regulated rate of return and is placed at risk through customer choice. Moreover, the restructuring of the industry at the wholesale level that has already occurred has addressed some stranded costs.

The primary stranded cost in the natural gas industry is for pipeline and storage capacity already under contract by the LDC to serve existing load. In recent years, the onset of full customer choice has been perceived as increasingly likely, and the duration of contracts has become shorter and shorter. Moreover, the slow adoption of customer choice means that existing stranded costs have been reduced as remaining terms are decreased and contracts expire. Over the extended time period for adoption of customer choice, utilities have had substantial opportunities to mitigate any stranded costs reflected in these contracts. Despite many opportunities to raise concerns with other stranded costs, such as regulatory assets, LDCs have not done so.

Thus, stranded costs in the gas industry are relatively small to begin with and already have been substantially mitigated. In addition, LDCs will incur some transition costs, such as for consumer education programs. While no industry wide totals are known, the industry total for all Pennsylvania LDCs is generally agreed to be in the range of tens of millions of dollars. While that it not an insubstantial sum, it pales in comparison to the tens of billions of dollars in stranded costs seen in the electric industry.

Notwithstanding the low level and relative simplicity of stranded costs in the natural gas industry, stranded costs have been a barrier to restructuring the industry thus far. There is no reason to permit stranded costs to prevent restructuring the natural gas industry. As the Commonwealth stepped back from its “principle” of collecting the GRT, utilities and consumers must step back from their “principle” responses to stranded costs as well. There is no reason that utilities must insist on 100% recovery of stranded costs. There is no reason for consumers to refuse to pay any stranded costs.

Columbia’s program provides a reality-check on the magnitude of the stranded costs and the dollars at issue for consumers and utilities. Columbia is collecting 3.0 Mcf to cover the $500,000 stranded and consumer education costs that it anticipates from 20,000 shopping customers. For a residential customer using 125 Mcf annually, the stranded cost charge is $3.75 annually. If 200,000 customers shopped, Columbia might predict approximately $5 million in stranded and transition costs, seeking approximately $37.50 annually from each customer to achieve equivalent stranded cost recovery.[16]

[16] This very rough calculation is designed only to provide a parameter for the relatively few dollars at issue in stranded cost recovery. Columbia’s estimates of stranded costs and its recovery assumptions have not

In addition, it should be noted that regulated utility customers have been paying and will continue to pay for potentially stranded costs as long as customer choice is forestalled. Similarly, it should be noted that utilities have accepted that industrial customers switching to transportation service in effect avoid paying these costs. Thus, it would not be unreasonable to propose that either LDCs or customers suppress "principled" responses to the issue of stranded cost recovery and agree to bear the costs in order to move forward. On the other hand, it would be unreasonable to allow stranded costs to undermine moving forward towards customer choice.

There are several simple ways to address stranded costs. In the four pilot programs, only Columbia identifies stranded costs for recovery. Peoples, NFG and Equitable do not identify any stranded or transition costs for recovery, although any stranded costs are recovered from consumers and/or suppliers through mandatory assignment of capacity contracts.

Mandatory assignment of existing contracts is an unnecessary anti-competitive barrier to the competitive market than cannot be justified on economic or policy terms. For example, Pennsylvania natural gas production can be delivered to the LDC without any interstate pipeline. Imposing such capacity costs on a supplier without any need for such service to begin with is inefficient, inequitable, and anti-competitive.

Mandatory assignment of existing contracts hides stranded costs and passes them on to all suppliers and all consumers without identifying any above-market costs as stranded costs that are being recovered. Moreover, mandatory assignment removes the opportunity for a competitive supplier to offer savings based on reduced pipeline and storage capacity costs. Mandatory assignment also removes the incentive for utilities to mitigate contract costs. Lastly, mandatory assignment of above-market pipeline and storage costs increases the shopping customer's price to purchase gas, reducing the incentive for the customer to shop and save.

Instead, it is easy enough to adopt a balanced approach that can eliminate stranded cost recovery problems while permitting the development of a competitive market expeditiously. Utilities have a full opportunity to mitigate contract costs by allowing existing contracts to expire, reserving incrementally less capacity in the future, and similar least-cost supply planning. Above-market contracts are being and must continue to be phased out. In addition, stranded contract capacity may not be above market but instead exist only because the utilities must supply a reduced volume of gas. Such capacity can be sold at market prices, further mitigating stranded costs. Lastly, since the gas industry does not exhibit overcapacity, new suppliers may want to purchase capacity no longer needed by the LDC. Indeed, LDC's should be required to sell unneeded

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been objectively reviewed by outside parties, and no suggestion is made that Columbia's assumptions or estimates are appropriate. Similarly, no assumption is made that other utilities have equivalent stranded costs, although there is no basis to conclude that other utilities have significantly higher levels of stranded costs.

capacity in order to ensure that suppliers have a meaningful opportunity to participate in the market.

The legislation should require aggressive mitigation of stranded costs and provide full recovery of any remaining net costs found by the Commission to exist. Contrary to the experience in the electric industry, determination of stranded costs must not be a time consuming litigated issue in advance of customer choice. Industrial customers have long been permitted choice without paying any stranded costs. Industrial customers, who avoided payment of the 5% GRT about 10 years before other customer classes, should be willing to pay a small, fair share of remaining stranded costs. Stranded costs should be collected from all shopping customers as a regulated, small surcharge over an appropriate number of years.

C. Rate Caps and Consumer Protection.

In the restructuring of the electric industry, substantial customer payments for utility stranded costs were balanced by rate caps to protect consumers. The minimal level of gas industry stranded costs and the guaranteed 5% rate reduction through elimination of the GRT makes thew issue less important as the gas industry is restructured.

Moreover, the high price volatility of the natural gas commodity renders rate protection for consumers problematic at best. In the natural gas industry, consumers have had limited protection from price volatility through the ECR mechanism that moderates recovery periods. Fundamentally, however, the consumer has borne the full risk of natural gas commodity price increases and received the benefit of price decreases. It would be hard to justify as a matter of public policy the implementation of a rate cap on natural gas commodity prices that never previously existed just as natural gas transitions from a regulated to a non-regulated commodity at the retail level.

However, some stranded costs will be recoverable from consumers. A utility should be subject to a non-commodity rate cap for regulated LDC services if stranded costs are recovered by the LDC.

Other basic consumer protections raise no difficulties either. Retention of the same basic consumer protection rules that presently exist, and were included in the electric restructuring legislation, should be included in the gas legislation.

C. Reorganizing the Former Monopolies and Default Service.

The LDC should unbundle its present service into separate rates for regulated services and competitive services such as gas supply, metering and billing. Consumers should pay only for the services they purchase from the LDC and be able to purchase competitive service from any licensed supplier. The LDC, as a regulated monopoly, should have the duty to provide transportation service to all customers and suppliers without discrimination.

Many of the natural gas utilities already have organized separate unregulated marketing affiliates that supply competitively priced natural gas supply services. Any utility seeking to participate in the unregulated retail gas supply market should operate that business with complete independence from the regulated LDC. Such independence is the simplest and most effective way to ensure non-discrimination and preclude cross-subsidization.

Several LDCs seek to exit the retail merchant function or provide retail gas supply services only through an unregulated affiliate. The LDC, as the distribution monopoly, should be required to exit the retail merchant function. Not all customers will immediately choose a competitive supplier. The obligation to supply gas to customers should end as soon as the Commission appoints one or more suppliers of competitive default service. A competitive default supplier will provide service to any customer not choosing or able to choose a supplier or whose supplier fails to deliver gas.

D. Conclusions

The foregoing recommendations certainly do not grant the wish list of any group interested in restructuring the natural gas industry, but do address realistic issues in a balanced way. All major interest groups benefit from the recommendations herein. The proposal could be adopted by the legislature and implemented by the PUC in time for the next heating season. The PUC should be given the direction and authority to implement the legislation and facilitate the development of a genuinely competitive market.

Several gas utilities already recognize that restructuring the natural gas industry is in their interests. All gas utilities should understand that the industry itself has an incentive to keep the price of gas low because there are competing alternative fuels. Lower natural gas prices makes gas more competitive with electricity, propane, coal or other energy sources. If natural gas garners a larger market share of energy use, an LDC can increase use of its distribution system, spread fixed costs, reduce regulated rates and earn increased revenues.

Elimination of the 5% GRT makes natural gas more competitive and should be a sufficient reason for a gas utility to support the proposed legislation. Since gas supply is provided at cost under traditional regulation, elimination of the monopoly and duty to sell natural gas is not necessarily a financial loss. In fact, restructuring can increase the flexibility of the utility to focus its resources and efforts in the most efficient manner. Any company seeking to participate in the competitive gas supply market can do so on the same terms as any other supplier. Any unmitigated net stranded costs can be fully recovered.

As in the electric industry restructuring, municipal utilities not regulated by the PUC or the Commonwealth should retain the right to determine how they operate. If they choose to compete beyond their municipal limits, however, they become regulated by the PUC and should be subject to the same rules as any other gas utility.

Thus, there is no reason for natural gas utilities to oppose the recommendations herein.

Suppliers seek an open market in which they are able to compete with former monopolies. The recommendations herein will open Pennsylvania for business for all competitive services without being subject to the will of the LDC. They will be able to operate more efficiently with competitive supply, capacity, metering and billing services and with more uniform rules across service territories. They will be able to operate pursuant to rules designed to encourage genuine competition.

Large industrial consumers were at the forefront of demands for electric customer choice and the gas transportation service that already exists. While they already have the benefits of customer choice and avoidance of the GRT, industrial customers place a premium on risk avoidance. Adoption of the legislation as proposed herein relieves industrial customers of the risk that the GRT will be reimposed upon them or that their freedom to choose will be restricted to match that afforded other natural gas customers. A decade of GRT and stranded cost avoidance should be more than sufficient to compensate for minimal future stranded cost responsibility.

Residential and commercial consumers should support the recommendations herein solely for avoidance of the 5% GRT, the opportunity to save a modest amount on gas bills, and the opportunity to choose fixed price service. They will achieve more price protection than currently exists and can be assured that basic consumer protections and programs can be retained as in the electric industry.