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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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

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[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

[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

[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.

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[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;

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[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

[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. (S*ee* 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

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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.