



COMMONWEALTH OF PENNSYLVANIA

February 25, 2014

E-Filed

Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street
Harrisburg, PA 17120

**Re: Petition of Generic Investigation or Rulemaking Regarding “Gas-On-Gas Competition” Between Jurisdictional Natural Gas Distribution Companies
Docket No. P-2011-2277868**

**Generic Investigation Regarding Gas-On-Gas Competition Between
Jurisdictional Natural Gas Distribution Companies
Docket No. I-2012-2320323**

Dear Secretary Chiavetta:

I am enclosing for filing today the Main Brief, on behalf of the Office of Small Business Advocate, in the above-docketed proceedings. As evidenced by the enclosed certificate of service, two copies have been served on all active parties in this case.

If you have any questions, please contact me.

Sincerely,

A handwritten signature in cursive script that reads "Elizabeth Rose Triscari".

Elizabeth Rose Triscari
Assistant Small Business Advocate
Attorney ID #306921

Enclosures

cc: Parties of Record

Robert D. Knecht

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**Petition for Generic Investigation or Rulemaking:
Regarding "Gas-On-Gas Competition" : Docket No. P-2011-2277868
Between Jurisdictional Natural Gas :
Distribution Companies :**

**Generic Investigation Regarding Gas-on-Gas :
Competition Between Jurisdictional Natural Gas : Docket No. I-2012-2320323
Distribution Companies :**

CERTIFICATE OF SERVICE

I certify that I am serving two copies of the Main Brief, on behalf of the Office of Small Business Advocate, by e-filing, e-mail, and/or first-class mail (unless otherwise noted) upon the persons addressed below:

Hon. Elizabeth H. Barnes
Administrative Law Judge
Pa. Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105
(717) 787-1191
(717) 787-0481 (fax)
ebarnes@pa.gov
(E-mail and Hand Delivery)

William H. Roberts, Esquire
Peoples Natural Gas Company, LLC
375 North Shore Drive - #600
Pittsburgh, PA 15212
(412) 208-6527
(412) 208-6577 (fax)
william.h.roberts@peoples-gas.com

Dawn Lindner, Esquire
Jennifer L. Petrisek, Esquire
Peoples TWP, LLC
205 N. Main Street
Butler, PA 16001
(724) 431-4924
dawn.lindner@peoples-gas.com
jennifer.petrisek@peoples-gas.com

Darryl A. Lawrence, Esquire
Aron J. Beatty, Esquire
Office of Consumer Advocate
555 Walnut Street - 5th Floor
Harrisburg, PA 17101-1923
(717) 783-5048
(717) 783-7152 (fax)
dlawrence@paoca.org
abeatty@paoca.org
(E-mail and Hand Delivery)

Allison C. Kaster, Esquire
Bureau of Investigation and Enforcement
Pa. Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105
(717) 787-1976
(717) 772-2677 (fax)
akaster@pa.gov
(E-mail and Hand Delivery)

David P. Zambito, Esquire
Cozen O'Connor
305 North Front Street - #400
Harrisburg, PA 17101-1236
(717) 703-5892
(215) 989-4216 (fax)
dzambito@cozen.com

Theodore J. Gallagher, Esquire
NiSource Corporate Services Company
121 Champion Way - #100
Canonsburg, PA 15317
(724) 416-6355
(724) 416-6384 (fax)
tjgallagher@nisource.com

Charles E. Thomas, Jr., Esquire
Thomas T. Niesen, Esquire
Thomas Long Niesen & Kennard
P. O. Box 9500
Harrisburg, PA 17108-9500
(717) 255-7615
(717) 236-8278 (fax)
cthomasjr@thomaslonglaw.com
tniesen@thomaslonglaw.com

David W. Gray, Esquire
Equitable Gas Company, LLC
225 North Shore Drive
Pittsburgh, PA 15212-5861
(412) 395-3634
(412) 395-3155 (fax)
dgray@equitablegas.com

Maureen Geary Krowicki, Esquire
National Fuel Gas Distribution Corp.
P. O. Box 2081
1100 State Street
Erie, PA 16512
(814) 871-8035
KrowickiM@natfuel.com

Amy Neufeld, Esquire
500 North Third Street - #800
Harrisburg, PA 17110
amy.neufeld@exeloncorp.com

Donna M. J. Clark, Esquire
Energy Association of Pennsylvania
800 North Third Street - #205
Harrisburg, PA 17101
dclark@energypa.org
(E-mail Only)

Mark C. Morrow, Esquire
Melanie J. Elatieh, Esquire
UGI Corporation
460 North Gulph Road
King of Prussia, PA 19406
(610) 768-3628
morrowm@ugicorp.com
Elatiehm@ugicorp.com

Thomas J. Sniscak, Esquire
William E. Lehman, Esquire
Hawke McKeon & Sniscak, LLP
P. O. Box 1778
Harrisburg, PA 17105
(717) 236-1300
tjsniscak@hmslegal.com
welehman@hmslegal.com

Teresa K. Schmittberger, Esquire
Pamela C. Polacek, Esquire
McNees Wallace and Nurick, LLC
P. O. Box 1166
Harrisburg, PA 17108
(717) 237-5270
tschmittberger@mwn.com
ppolacek@mwn.com


Michael S. Swerling, Esquire
PECO Energy Company
2301 Market Street - S23-1
Philadelphia, PA 19101-8699
(215) 841-4220
(215) 568-3389 (fax)
michael.swerling@exeloncorp.com

Kevin J. Moody, Esquire
Pennsylvania Independent Oil & Gas Assoc.
212 Locust Street - #300
Harrisburg, PA 17101-1510
(717) 234-8525 ext. 113
(717) 234-8812 (fax)
kevin@pioga.org

Tishekia E. Williams, Esquire
Duquesne Light Company
411 Seventh Avenue
Pittsburgh, PA 15219
(412) 393-1541
(412) 393-5757 (fax)
Twilliams@duqlight.com

James L. Crist
JLCrist@aol.com
(E-mail Only)

Benjamin L. Shechtman, Esquire
Stevens & Lee
620 Freedom Business Center - #200
King of Prussia, PA 19406
(610) 205-6010
bls@stevenslee.com


Elizabeth Rose Triscari
Assistant Small Business Advocate
Attorney ID No. 306921

Date: February 25, 2014

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Petition for Generic Investigation or Rulemaking :	
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Generic Investigation Regarding Gas-on-Gas :	
Competition Between Jurisdictional Natural Gas :	Docket No. I-2012-2320323
Distribution Companies :	

**MAIN BRIEF
ON BEHALF OF THE
OFFICE OF SMALL BUSINESS ADVOCATE**

**Elizabeth Rose Triscari
Assistant Small Business Advocate
Attorney ID # 306921**

**For: John R. Evans
Small Business Advocate**

**Office of Small Business Advocate
300 North Second Street - Suite 1102
Harrisburg, PA 17101**

Dated: February 25, 2014

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and Equitable Gas Company LLC for All of the Authority and the Necessary
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I. FACTUAL AND PROCEDURAL BACKGROUND

A. Genesis of Gas-on-Gas “Competition” Investigation

For historical reasons, certain geographical areas in western Pennsylvania lie within the service territories of more than one natural gas distribution company (“NGDC”). For many years, the Pennsylvania Public Utility Commission (“Commission”) has permitted NGDCs to discount or “flex” regular tariff rates to customers in these areas in response to lower price offers from another NGDC. NGDCs offering such discounted rates are then permitted to recover revenue shortfalls associated with these discounts in base rates proceedings from regular rate “captive” customers without other alternatives. This policy is commonly referred to as “gas-on-gas competition.”

The Office of Small Business Advocate (“OSBA”) and its experts have opposed the practice known as gas-on-gas competition for nearly twenty years.¹ The OSBA’s position has consistently been that gas-on-gas “competition” is not competition at all. Rather, it is an inequitable form of price discrimination, where rates are set not on cost to serve differences, but solely on whether a customer’s location entitles it to be served by another NGDC.

Accordingly, on December 8, 2011, the OSBA, together with the Bureau of Investigation and Enforcement (“I&E”), Office of Consumer Advocate (“OCA”), Peoples TWP LLC (“PTWP”), and Peoples Natural Gas Company (“Peoples”) filed a Joint Petition requesting that the Commission institute an investigation or rulemaking to address distribution base rate discounting among NGDCs with overlapping service territories, *i.e.*, gas-on-gas competition.

The Joint Petition arose out of the settlement of Peoples’ 2010 base rate proceeding at Docket No. R-2010-2201702 (“Peoples Settlement”). In the Peoples Settlement, Peoples, I&E,

¹ OSBA Statement No. 1 at 6 (citing OSBA Statement No. 1 (Knecht), Docket No. R-00953406, October 1995).

the OCA, and the OSBA agreed that issues related to gas-on-gas competition should be resolved by requesting a generic proceeding rather than in Peoples' base rate case.

At the time of the Peoples Settlement, other NGDCs had also agreed that gas-on-gas competition issues should be uniformly resolved on a state-wide basis; specifically, Equitable Gas Company LLC ("Equitable") in the settlement of its 2008 base rate proceeding at Docket No. R-2008-2029325, Columbia Gas of Pennsylvania, Inc. ("Columbia") in the settlement of its 2010 base rate proceeding at Docket No. R-2010-2215623, and PTWP in the settlement of its acquisition of T.W. Phillips Gas and Oil Co. at Docket No. A-2010-2210326.

In response to the Joint Petition, the Commission issued a Secretarial Letter on July 25, 2012, initiating a generic investigation (the "Investigation") and referring this matter to the Office of Administrative Law Judge. The matter was assigned to Administrative Law Judge ("ALJ") Elizabeth H. Barnes who issued a Prehearing Conference Order on August 23, 2012, inviting other parties to intervene and participate in the Investigation. Petitions to Intervene were filed by The Pennsylvania State University ("Penn State"), National Fuel Gas Distribution Corporation ("NFG"), The Industrial Energy Consumers of Pennsylvania ("IECPA"), PECO Energy Company ("PECO"), UGI Distribution Companies ("UGI"), Columbia, and Equitable.²

B. Investigation Delays

1. Scope of Investigation

At the Initial Prehearing Conference, the parties disagreed about the appropriate scope of the Investigation. The participating NGDCs argued that the Commission's Secretarial Letter had greatly limited the scope from that requested in the Joint Petition. They argued that this proceeding should not deal with the question of whether gas-on-gas competition should be

² Subsequent Petitions to Intervene filed by the Pennsylvania Independent Oil & Gas Association ("PIOGA") and Duquesne Light Company ("Duquesne") were granted at the Second Prehearing Conference on January 24, 2013.

permitted to continue, but rather should only seek comments from parties on how flexed revenues should be treated for ratemaking purposes. The OSBA and the other statutory advocates, in contrast, argued that the Secretarial Letter did not intend to limit the scope of the proceeding from that requested in the Joint Petition and that a more comprehensive proceeding was required, including discovery, testimony, evidentiary hearings, and briefs.

ALJ Barnes issued a Prehearing Order on August 31, 2012, directing the parties to file formal comments regarding the appropriate scope of issues to be addressed in the Investigation. Accordingly, the OSBA, OCA, I&E, Equitable, IECPA, Penn State, Columbia, and Peoples each filed comments.

On December 11, 2012, ALJ Barnes issued an Order, which determined the proper scope of the Investigation and stated in pertinent part:

Upon review of the parties' comments, I agree with BI&E, OCA and OSBA that the intention of the Secretarial Letter was to initiate a fully litigated proceeding, specifically to determine the full impact of flexing distribution rates, to address if this competition should be allowed to continue, and if so, how that should be fairly applied as outlined in the Joint Petition for Settlement, page 4. The merits of gas-on-gas competition shall be a part of the scope of this proceeding...A more in-depth procedure than just a comment period will be required and discovery will be allowed such that the parties will have time to evaluate the scope of the issues so that potential remedies can be evaluated.³

The Order also scheduled a Second Prehearing Conference for January 24, 2013.

2. Equitable Acquisition

On December 20, 2012, Peoples issued a press release announcing its agreement to acquire Equitable (the "Equitable Acquisition"), an NGDC whose service territory overlaps with Peoples/PTWP. Peoples/PTWP filed a Motion on January 23, 2013, requesting that the

³ *Generic Investigation Regarding Gas-On-Gas Competition Between Jurisdictional Natural Gas Distribution Companies*, Docket No. I-2012-2320323 (Order entered December 11, 2012) at 4.

Investigation be held in abeyance pending final Commission action with respect to the Equitable Acquisition. It also requested that the Motion be decided the following day at the Second Prehearing Conference.

The Second Prehearing Conference was held on January 24, 2013, as scheduled. ALJ Barnes did not rule on Peoples/PTWP's Motion, instead allowing the parties the opportunity to provide a written response as provided for in the Commission's regulations. After the filing of responses, ALJ Barnes denied Peoples/PTWP's request to hold this proceeding in abeyance and set a procedural schedule by Order dated February 13, 2013.

3. Protective Order and Discovery

Also discussed at the Second Prehearing Conference was the necessity of a protective order, but the parties were unable to agree on the terms. Given the sensitive nature of the discovery requests the OSBA had served on January 18, 2013, and believing a protective order to be imminent, the OSBA granted the NGDCs' request to extend the time to object or respond to its discovery requests until a protective order was entered. Unfortunately, after extensive negotiations lasting over two months, the parties were ultimately unable to reach consensus on a protective order. On April 3, 2013, Peoples/PTWP filed a Motion for Protective Order and Proposed Order. Following the filing of answers to the Motion for Protective Order by interested parties, ALJ Barnes issued a Protective Order on May 2, 2013, substantially similar to the one proposed by Peoples/PTWP. Given this more than three-month delay of the commencement of discovery, the procedural schedule was modified at the request of the parties to extend the time for discovery. Extensive discovery was subsequently exchanged.

C. Admission of Testimony and Closing of the Record

Following discovery, the OSBA served on the parties and ALJ Barnes OSBA Statement No. 1 (the Direct Testimony and Exhibits of Robert D. Knecht), OSBA Statement No. 2 (the Rebuttal Testimony of Robert D. Knecht), and OSBA Statement No. 3 (the Surrebuttal Testimony of Robert D. Knecht) on August 8, 2013, October 17, 2013, and November 26, 2013, respectively.

Prior to the scheduled evidentiary hearings and with the consent of the ALJ, the parties agreed to waive rejoinder testimony and cross-examination of witnesses and to admit previously served testimony by stipulation. A hearing was held on December 10, 2013, at which time OSBA Statement No. 1, OSBA Statement No. 2, and OSBA Statement No. 3, as well as the other parties' testimony and exhibits were entered into the record. It was also agreed to at the hearing that the record would remain open to permit Peoples to submit confirmation of the closing of its acquisition of Equitable.

Subsequent to the hearing, the parties engaged in settlement negotiations. It was agreed to by the parties that the procedural schedule should again be modified to allow for additional time for settlement talks. ALJ Barnes granted the parties' request to extend the due date for briefs by two weeks. The procedural schedule was amended by order dated January 23, 2014, to have Main Briefs filed on February 11, 2014, and Reply Briefs on February 28, 2014.

Also on January 23, 2014, Peoples/PTWP filed an unopposed letter motion to enter into the record Peoples/PTWP Statement No. 1-Supp and request that the record thereafter be closed. This supplemental testimony confirmed the consummation of the acquisition of Equitable on December 17, 2013, pursuant to Commission approval at Docket No. A-2013-2353647. Equitable was acquired by Peoples' parent company, PNG Companies LLC, and was then

merged with Peoples with the surviving legal entity being Peoples Natural Gas Company – Equitable Division.⁴ Although the testimony admitted into the record by the former entity (Equitable Gas Company LLC) was not withdrawn or stricken from the record, it was not adopted by the surviving legal entity (Peoples Natural Gas Company – Equitable Division).

The procedural schedule was amended a third time at the request of the parties, by order dated February 7, 2014, to allow for an additional two weeks for settlement discussions. The order directed Main Briefs to be filed on February 25, 2014 and Rely Briefs on March 12, 2014.

Despite good faith settlement negotiations, the parties were unable to reach a unanimous settlement of this proceeding. Therefore, the OSBA submits this Main Brief in accordance with the procedural schedule, as amended.

⁴ Peoples/PTWP Statement No. 1-Supp. at 2.

II. SUMMARY OF ARGUMENT

The practice often referred to as gas-on-gas “competition” is a misnomer. The appropriate term for the practice is gas-on-gas “price discrimination.” However, for the purposes of this Main Brief, the OSBA will refer herein to the practice as gas-on-gas “discounting.”

When offering gas-on-gas discounted rates, NGDCs set prices not on differences in cost to serve, but rather solely on whether a customer’s location entitles it to be served by another NGDC.

This violates the “polestar” of ratemaking criteria and results in discriminatory rates.

Claims that gas-on-gas discounting is competition beneficial to all ratepayers are incorrect and therefore do not provide any justification for these discriminatory rates. When an NGDC offers discounts to customers that just happen to be lucky enough to lie within overlapping NGDC service territories, only to then recover revenue shortfalls associated with these discounts from not-so-lucky captive ratepayers, it is not actual competition. Rather, it is inequitable price discrimination resulting in millions of dollars of undue intra-class subsidization of flex rate customers by captive customers.

Gas-on-gas discounting has no economic or social benefit to the overall base of Pennsylvania NGDC customers and should therefore be eliminated as quickly as is practicable. The OSBA recognizes, however, that this discriminatory policy has been in place for many years and that many NGDCs and flex rate customers have entered into contracts for discounted rates in good faith. Therefore, the OSBA supports a reasonable transition away from gas-on-gas discounting in which no new gas-on-gas discounts are offered, existing agreements are reasonably phased out, and NGDCs compete on regular tariff rates going forward.

III. ARGUMENT

A. Extent of Gas-on-Gas Discounting in Pennsylvania and Limited Effect of Consolidation of the Gas Distribution Industry

The OSBA submitted interrogatories directed to the Commonwealth's NGDCs to evaluate the current extent of gas-on-gas discounting in Pennsylvania. The OSBA asked each NGDC to provide a list of customers that receive a "gas-on-gas" discounted rate, showing the annual load, rate class, contract termination date, flex rate revenues, and full tariff rate revenues for the customer. A summary of the data provided is shown in Table OSBA-1 below.⁵

TABLE OSBA-1 SUMMARY OF GAS-ON-GAS RATE DISCOUNTING								
		"Competitor" NGDC						
		Columbia	Equitable	Peoples	PTWP	Combined	Total	
Supplying NGDC	Columbia	Number		10	13	1	--	24
		Volume		924,539	1,799,496	8,304	--	2,732,339
		Shortfall		\$300.3	\$1,031.2	\$0.2	--	\$1,331.8
	Equitable	Number	28		103	Note (3)	55	186
		Volume	323,920		3,919,699		878,866	5,122,484
		Shortfall	\$394.7		\$6,616.2		\$381.3	\$7,392.2
	Peoples	Number	21	95		13	2	130
		Volume	1,809,318	4,373,545		444,713	58,547	6,686,123
		Shortfall	\$2,600.9	\$5,734.5		\$658.0	\$58.5	\$9,051.9
	PTWP	Number	1	10	50		--	61
		Volume	9,000	383,057	835,257		--	1,227,314
		Shortfall	\$15.2	\$269.4	\$963.8		--	\$1,248.4
Total	Number	50	114	166	14	57	401	
	Volume	2,142,238	5,681,141	6,554,452	453,017	937,413	15,768,260	
	Shortfall	\$3,010.8	\$6,304.2	\$8,611.2	\$658.3	\$439.9	\$19,024.4	

Notes:

- 1) Volumes are in mcf, except for Columbia, which reports data in Dth.
- 2) Shortfall is difference between full tariff and discounted tariff revenues, in \$000.
- 3) Equitable appears to have combined Peoples and PTWP for competitor identification purposes. Values are recorded in Peoples Natural Gas in this summary.
- 4) Equitable includes some customers with pipeline or other economic bypass in its list. These customers are excluded from this comparison.
- 5) The Equitable "Combined" category is Columbia and Peoples/TWP.
- 6) Equitable customer count is based on "Customer Group ID." Many customer groups have multiple locations, with different classes of service at different locations.
- 7) Peoples "Combined" category is Equitable and Columbia.
- 8) Source: NGDC responses to OSBA-I-2, OSBA-II-1 and OSBA-II-2.

⁵ Reprinted from OSBA Statement No. 1 at 8.

Based on the responses to the OSBA's interrogatories, it appears that gas-on-gas discounting is limited to four NGDCs, namely Columbia, Equitable, Peoples, and PTWP. Gas-on-gas discounting involves 400 customers, 15.8 Bcf per year of gas, and a \$19.0 million annual shortfall in revenues being imposed on regular rate customers.⁶ The OSBA acknowledges that much of this price discrimination takes place between NGDCs that have merged or are otherwise affiliated. Peoples and PTWP are now affiliates and Equitable has been acquired and merged into Peoples. If gas-on-gas discounting were eliminated among Peoples, PTWP, and Equitable, the problem would be limited to 74 customers, 4.9 Bcf per year of gas, and a \$4.3 million annual shortfall in revenues being imposed on regular rate customers.⁷ However, gas-on-gas discounting among these NGDCs has not, in fact, been eliminated. As a condition of the Peoples/PTWP merger, flex rate discounts are extended at least through December 31, 2016.⁸ In the case of Peoples' acquisition of Equitable, the parties agreed to extend existing flex rate discounts (to customers lying in the service territories of both Peoples/PTWP and Equitable) through December 2018, or through the end of the contract by its own terms, whichever is later.⁹

Consolidation in the gas distribution industry has therefore had no immediate impact on customers with respect to gas-on-gas discounting. While these mergers will affect customers in the long-term, in the short-term, flex rate agreements remain in place and continue to force captive ratepayers to make up for revenue shortfalls associated with gas-on-gas discounting. Moreover, if gas-on-gas discounting policies remain unchanged, captive ratepayers will continue

⁶ OSBA Statement No. 1 at 5.

⁷ *Id.* at 5-6.

⁸ *Id.* at 6.

⁹ *Id.*

to subsidize flex rate contracts with customers in the overlapping service territories of Columbia and the Peoples affiliates.

B. Gas-on-Gas “Competition” is Not Actually Competition

Competition has generally been deemed to be economically superior to price regulation.¹⁰ Both the Pennsylvania state legislature and the Commission have recognized the benefits of competition in allowing both wholesale and retail competition in electric and natural gas supply.¹¹ If gas-on-gas discounting were, in fact, “competition,” the OSBA might take a different position. However, simply calling something competition does not mean it affords the benefits of competition.

OSBA witness Robert D. Knecht explained in his testimony the four benefits of *actual* competition and why each of these benefits does not apply to the incorrectly dubbed gas-on-gas “competition.”¹² The first is productive efficiency, which is when producers strive to produce goods at as low a cost as possible, thereby increasing their own profits, but also keeping market prices down.¹³ However, productive efficiency does not apply here because NGDCs have no more incentive to reduce their cost of providing service under gas-on-gas discounting than they do under rate regulation because any lost revenues associated with price discounts are passed on to captive ratepayers. Therefore, NGDCs have no incentive to reduce costs in order to meet “competitive” threats from other NGDCs.¹⁴

¹⁰ OSBA Statement No. 1 at 2 (citing, e.g., *Principles of Public Utility Rates, Second Edition*; Bonbright, Dantelsen, Kamerschen; “Regulation: An Imperfect Substitute for Competition,” pages 29 – 33, 1988.)

¹¹ *Id.* at 2.

¹² *Id.* at 2-4.

¹³ *Id.* at 2.

¹⁴ *Id.* at 3.

Another benefit of actual competition is allocative efficiency.¹⁵ Prices in a competitive market are generally set at the marginal cost of the high cost producer, therefore providing the precisely correct market price signal to customers who are evaluating whether to purchase the product.¹⁶ Once again, this does not apply to gas-on-gas discounting. While customers who are located in overlapping service territories may face rates that are closer to short-run marginal cost than are tariff rates, the NGDC customers outside those areas face rates that are further removed from marginal cost because they are subsidizing flex rate customers.¹⁷ Moreover, since most NGDCs assume the marginal costs associated with existing facilities is zero in their economic evaluation of flex rates, it is unclear that flex rates are closer to the long-run marginal costs of providing service to flex rate customers.¹⁸

Dynamic efficiency is also a benefit of actual competition.¹⁹ Competition can spur both product and process innovation, thereby reducing prices to consumers over the longer term.²⁰ However, as is the case for productive efficiency, gas-on-gas discounting creates no additional incentive for innovation relative to normal regulated rates. Discounting is not based on cost reductions or efficiency gains. Rather, it is based only on passing revenue shortfalls onto captive customers who have no other alternatives.²¹

¹⁵ OSBA Statement No. 1 at 2.

¹⁶ *Id.*

¹⁷ *Id.* at 3.

¹⁸ *Id.*

¹⁹ *Id.* at 2.

²⁰ *Id.*

²¹ *Id.* at 3.

Finally, equity is a benefit of actual competition.²² In fully competitive markets, consumers who purchase the same good pay the same market price for that good, with price differentiations based only on the differences in the cost of providing service. Gas-on-gas discounting, in contrast, is anything but equitable, in that rates paid by customers with exactly the same cost to serve can be substantially different. Gas-on-gas discounts violate the equity precept that equals be treated equally, and unequals be treated unequally.²³

Therefore, any party arguing that gas-on-gas “competition” is actual competition is ignoring basic economic theory. They are confusing competition with price discrimination. As Mr. Knecht explains:

Competition can take many forms, including cost reductions, profit reductions, improved service, improved product quality, innovation, and a variety of other actions intended to provide a greater benefit to customers served by the supplier. What the Pennsylvania NGDCs do is simply lower their prices to some specially situated customers, and then charge the shortfall to the captive customer base. This is price discrimination, which is achievable only because the NGDC has a set of captive customers from whom it can recover the discounts.²⁴

Misguided claims that gas-on-gas discounting is competition do not justify this discriminatory practice.

C. Gas-on-Gas Discounting Does Not Benefit All Ratepayers

Some parties have also argued that gas-on-gas discounting benefits all ratepayers because it enables an NGDC to retain a customer or add new load resulting in more contributions to that

²² OSBA Statement No. 1 at 2.

²³ *Id.* at 3.

²⁴ OSBA Statement No. 2 at 6.

NGDC's fixed cost recovery.²⁵ This argument is stubbornly premised in the context of a single NGDC's base rates proceeding. In that limited context, it would generally be preferable to obtain or retain a customer even at a discounted rate rather than to completely lose the revenue it generates.²⁶

However, this is a statewide generic investigation where the economics are completely different. Gas-on-gas discounting must be evaluated, not on a company-by-company basis, but rather whether the policy benefits *all* Pennsylvania NGDC customers.²⁷ When the blinders are removed and gas-on-gas discounting is evaluated in this broader context, the appropriate question becomes whether gas-on-gas discounts are beneficial, not to the customers of *one* NGDC, but to the *overall* Pennsylvania customer base. In other words, are gas-on-gas discounts necessary to retain existing customers or attract new customers to *any* Pennsylvania NGDC? The answer is a resounding no.

Under this definition, flex rate discounts used in response to real competitive threats, such as, interstate pipeline bypass, alternative fuel competition, or local gas suppliers, or to promote economic development, may be economically justified (and as such, are outside the scope of this Investigation).²⁸ However, flex rate discounts offered only to keep a customer from switching to another Pennsylvania NGDC, as is the case with gas-on-gas discounts, do not provide a benefit to the overall Pennsylvania NGDC customer base.²⁹

²⁵ See, e.g., IECPA Statement No. 1 at 3; Equitable Statement No. 1 at 6.

²⁶ OSBA Statement No. 2 at 3.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

Consider OSBA witness Mr. Knecht's example at pp. 3-4 of his rebuttal testimony. Assume a hypothetical large industrial customer ("Customer") with annual throughput of 500,000 Mcf lies in the overlapping service territories of PTWP and Columbia.³⁰ Under the current regular tariff rates of Columbia (Rate LDS), the Customer would pay distribution charges of approximately \$424,000 annually. Under the regular tariff rates of PTWP (Rate LGS-II), the Customer would pay approximately \$547,000 annually. PTWP, which presumably deems the incremental distribution cost of serving the Customer to be zero, is therefore likely willing to offer the Customer any flex rate greater than zero. Accordingly, suppose PTWP enters into a flex rate agreement where the Customer pays \$100,000 annually, which is a deep discount of \$447,000 below PTWP's regular tariff rates. To the regular ratepayers of PTWP, this appears to be a pretty good deal. PTWP earns \$100,000 per year from the Customer it would not have otherwise earned if the Customer had not been offered a discounted rate. If the Customer had instead decided to take service from Columbia, PTWP's ratepayers would have to make up the \$100,000 difference in revenue earned. Thus, in PTWP's base rates proceeding, the parties and the Commission would logically deem the discount offered to the Customer to be reasonable. Proponents of gas-on-gas discounting tend to halt their analysis there, but this is not the entire picture.

Now consider the same example in the context of a generic proceeding. If gas-on-gas discounts are permitted, the *combined* customer base of PTWP and Columbia will earn revenues of \$100,000 annually from the Customer. However, if discounts are not permitted, the Customer will presumably choose the lower cost option (Columbia) and pay \$424,000 annually. Instead of the \$100,000 earned if gas-on-gas discounts are permitted, the combined customer base of

³⁰ OSBA Statement No. 2 at 3-4.

PTWP and Columbia will earn annual revenues of \$424,000 from the Customer. Thus, the Commission policy of gas-on-gas discounting imposes net additional costs to the combined base of regular tariff ratepayers of \$324,000 (\$424,000 in revenues under regular tariff rates less \$100,000 in revenues under discounted rates). If, instead, gas-on-gas discounts are prohibited, there is a benefit of \$424,000 to regular Columbia ratepayers and an incremental cost of \$100,000 to regular PTWP ratepayers, or a *net* benefit to the overall customer base of regular ratepayers of \$324,000.

This example illustrates how the argument that gas-on-gas discounts benefit all customers is simply wrong. Gas-on-gas discounts are nothing more than an inequitable and unduly discriminatory economic transfer from captive customers who cannot get such discounts to those customers who can.³¹ The practice of gas-on-gas discounting does not benefit all ratepayers and should be eliminated.

D. Gas-on-Gas Discounting Violates Key Rate Design Criteria

In an appeal brought by the OSBA, the Commonwealth Court held “that rates and rate structures [must] be set for each service primarily on a cost-of-service study.” Although the Court indicated that the Commission may consider other factors, the Court characterized cost of service as the “polestar” of ratemaking concerns.³² The Court further held that other rate-making concerns (in that case gradualism) could not trump cost of providing service.³³ However, in apparent disregard of the holding in *Lloyd*, gas-on-gas discounting effectively ignores the cost of providing service to a customer and instead permits NGDCs to set rates based solely on whether

³¹ OSBA Statement No. 2 at 4. Moreover, the nature of overlapping service territories likely leads to excess spending on duplicative facilities, resulting in a net loss for Pennsylvania ratepayers.

³² *Lloyd v. Pennsylvania Public Utility Commission*, 904 A.2d 1010, 1020 (Pa. Cmwlth. 2006), *appeals denied*, 916 A.2d 1104 (Pa. 2007).

³³ *Id.*

a customer's location permits it to be served by another NGDC. This method of rate-setting unduly discriminates against customers based on their location, requiring captive customers to subsidize customers with other options.

Section 1304 of the Public Utility Code prohibits such discriminatory ratemaking. It states, in pertinent part:

No public utility shall, as to rates, make or grant any unreasonable preference or advantage to any person, corporation, or municipal corporation, or subject any person, corporation, or municipal corporation to any unreasonable prejudice or disadvantage.³⁴

Gas-on-gas discounting violates Section 1304 of the Public Utility Code because it grants an unreasonable preference to flex rate customers (discounted rates) while subjecting captive customers to an unreasonable disadvantage (subsidizing discounted rates). The primary justification offered by proponents of these discriminatory rates is that gas-on-gas discounting is competition that benefits all ratepayers. However, the OSBA has clearly shown this alleged justification to be false. Gas-on-gas discounting is not competition and it does not benefit all ratepayers. It is simply undue price discrimination that should not be permitted to continue.

Furthermore, gas-on-gas rate discounting not only violates the critical cost of service criterion of ratemaking, but also virtually all other key rate design criteria.³⁵ The rate stability criterion is violated because rates offered to any particular customer are at the discretion of NGDCs who can just pass costs on to other ratepayers. Gas-on-gas discounted rates do not reflect value of service because customers who value service equally may face very different rates based only on location. The revenue stability criterion is violated because customers can

³⁴ 66 Pa. C.S. §1304.

³⁵ OSBA Statement No. 2 at 7-8.

switch between NGDCs causing the revenue requirements of individual NGDCs to fluctuate. Gas-on-gas flex rates are dynamically inefficient because they encourage duplication of gas distribution facilities in overlapping service territories. Gas-on-gas flex rates are inequitable, in that comparable customers are not treated comparably. Finally gas-on-gas flex rates are not simple, understandable, or free from controversy as to interpretation. In summary, gas-on-gas flex rates fail on both cost and non-cost rate design criteria.³⁶ They should be eliminated.

E. OSBA Recommendation For Reasonable Phase-Out of Gas-on-Gas Discounting

For all of the reasons enumerated above, the OSBA recommends that gas-on-gas discounting be reasonably phased out over as short a time period as is practicable and that NGDCs be required to compete on regular tariff rates going forward.³⁷

Specifically, NGDCs should not be permitted to offer a below regular tariff rate to any customer of another NGDC upon entry of a final order in this Investigation.³⁸ NGDCs may, however, offer service to customers taking service from another NGDC at regular tariff rates. Regular tariff rates have been deemed by the Commission to be just and reasonable and can be modified on a going forward basis, if necessary, to better reflect costs.³⁹

Upon entry of a final order in this Investigation, no NGDC should be permitted to renew or extend any agreement that it has with its own customers for a discounted rate that originates solely from a threat of lower prices from another Pennsylvania NGDC.⁴⁰

³⁶ OSBA Statement No. 2 at 8.

³⁷ OSBA Statement No. 1 at 6.

³⁸ *Id.*

³⁹ *Id.* at 6-7.

⁴⁰ *Id.* at 7.

NGDCs should be permitted to recover the revenue shortfall associated with existing flex rate agreements, but only through their current expiration date or December 31, 2016, whichever is earlier.⁴¹ If a customer's flex rate agreement expires before December 31, 2016, it should be transitioned to regular tariff rates. If a customer's flex rate agreement expires after December 31, 2016, the NGDC should be permitted (and depending on the provisions of the agreement may be obligated) to continue to provide service at the discounted rate. However, the NGDC should not be permitted to recover from other customers in a subsequent base rates proceeding the revenue shortfall associated with discounted rates paid after December 31, 2016,.

Correspondingly, NGDCs should be permitted to retain any increase in revenues they earn associated with the expiration of gas-on-gas flex rate agreements until the time of their next base rate case.⁴²

The OSBA has recommended December 31, 2016, as a hard end date after which NGDCs should not be permitted to recover the revenue shortfall associated with gas-on-gas discounting from captive ratepayers for several reasons. First, as a practical matter, based on a review of the contract termination dates for most flex rate agreements, the vast majority have end dates prior to December 31, 2016.⁴³ Thus, the number of contracts affected by the OSBA's proposed "sunset" date is relatively small.⁴⁴

Second, NGDCs and flex rate customers should not be rewarded for imprudently entering into unusually long-term flex rate agreements without including a boilerplate contract provision

⁴¹ OSBA Statement No. 1 at 7.

⁴² *Id.*

⁴³ *Id.*

⁴⁴ OSBA Statement No. 2 at 4-5.

to protect themselves against a change in regulatory law or policy.⁴⁵ NGDCs and flex rate customers have been aware for many years that the statutory advocates oppose gas-on-gas discounting. To the extent that sophisticated entities like NGDCs and flex rate customers have accepted the risk of a change in regulatory policy, they presumably did so with their eyes open.⁴⁶ The OSBA also has concerns about NGDCs and flex rate customers “gaming the system” by entering into longer-term contracts when it became clear that the Commission was revisiting its policy.⁴⁷

Third, just as NGDCs and flex rate customers should not be rewarded for entering into unusually long flex rate agreements, captive ratepayers should not be punished by them, especially since these ratepayers are not a party to the agreements. NGDCs and flex rate customers entered into a mutually beneficial arrangement at the expense of a third party that was not represented in the negotiations, despite being forced to bear the costs.⁴⁸ Fairness dictates that regular rate customers, who have been paying excessive rates for years, not be required to continue to pay these higher rates just because an agreement exists to which they did not consent and were not a party.

Fourth, implementing a sunset date with respect to the allowability of flex rate agreements does not conflict with any previous settlement or Commission decision in prior base rates cases. The Commission’s previous acceptance of gas-on-gas discounts when determining an NGDC’s revenue requirement has been generally based on test year considerations and not a

⁴⁵ OSBA Statement No. 1 at 8.

⁴⁶ OSBA Statement No. 3 at 4.

⁴⁷ *Id.*

⁴⁸ *Id.* at 6.

detailed evaluation of the discounting over the entire duration of the contract.⁴⁹ Thus, longer term gas-on-gas contracts have generally not been evaluated and approved for anything more than the test year used in an NGDC's last base rates case.

Finally, the OSBA's proposed end date is a full four years past when this proceeding was initiated and will likely be over two years after when a Commission decision is anticipated in this Investigation, leaving more than adequate time for making necessary transitions from flex rates to regular tariff rates.⁵⁰

However, if the Commission disagrees with the OSBA and determines that a fixed sunset date is inappropriate, the OSBA recommends that the issue of the allowability or prudence of existing gas-on-gas flex agreements be deferred until each of the NGDCs' next base rates case.⁵¹ To achieve Commission approval of the gas-on-gas flex agreements and therefore recover the revenue shortfall from captive ratepayers, the NGDC would need to demonstrate that, at the time the contract was entered into and/or most recently renewed: (1) the discounted rate was necessary to meet a firm offer from a different NGDC; (2) the term of the contract was necessary to meet a firm offer from a different NGDC; and (3) the revenues from the contract were believed to be sufficient to reflect the longer-term incremental costs of providing service to that customer, including a reasonable provision for the replacement of assets used to serve that customer (or a clear demonstration that no such costs would be incurred).⁵²

⁴⁹ OSBA Statement No. 3 at 5.

⁵⁰ OSBA Statement No. 1 at 8.

⁵¹ OSBA Statement No. 3 at 6.

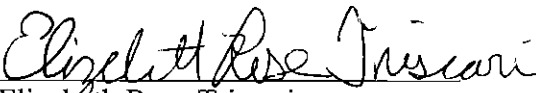
⁵² *Id.*

V. CONCLUSION

For the reasons set forth above, the OSBA respectfully requests that the ALJ and the Commission:

- (1) Prohibit NGDCs from entering into new agreements or renewing existing agreements that offer a below regular tariff rate to obtain or retain a customer that has the option of taking service from another NGDC, but does not have real competitive supply options such as interstate pipeline bypass, alternative fuel capability, or local gas supply,; and
- (2) Permit NGDCs to recover the revenue shortfall in base rates proceedings of existing discount agreements, but only through such agreements' current expiration date or December 31, 2016, whichever is earlier.

Respectfully submitted,


Elizabeth Rose Triscari
Assistant Small Business Advocate
Attorney ID No. 306921

For:

John R. Evans
Small Business Advocate

Office of Small Business Advocate
300 North Second Street, Suite 1102
Harrisburg, PA 17101

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