



COMMONWEALTH OF PENNSYLVANIA

July 24, 2014

E-FILED

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

Re: Joint Petition for 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:

Enclosed for filing are the Reply Exceptions, 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 do not hesitate to contact me.

Sincerely,

Elizabeth Rose Triscari
Deputy Small Business Advocate
Attorney ID #306921

Enclosures

**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 Reply Exceptions, 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:

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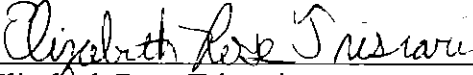
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Date: July 24, 2014

**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 :

**REPLY EXCEPTIONS
ON BEHALF OF THE
OFFICE OF SMALL BUSINESS ADVOCATE**

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Dated: July 24, 2014

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I. INTRODUCTION

On December 8, 2011, the Office of Small Business Advocate (“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 with the Pennsylvania Public Utility Commission (“Commission”) requesting that the Commission institute an investigation or rulemaking to address distribution base rate discounting among natural gas distribution companies (“NGDCs”) with overlapping service territories, *i.e.*, gas-on-gas competition.

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.¹

At the Initial Prehearing Conference, the parties disagreed about the appropriate scope of the Investigation. 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.

¹ 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.

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.²

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

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 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.

² *Generic Investigation Regarding Gas-On-Gas Competition Between Jurisdictional Natural Gas Distribution Companies*, Docket No. 1-2012-2320323 (Order entered December 11, 2012) at 4.

Also discussed at the Second Prehearing Conference was the necessity of a protective order, but the parties were unable to agree on the terms. 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.

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.³ 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 Reply Briefs on March 12, 2014.

Despite good faith settlement negotiations, the parties were unable to reach a unanimous settlement of this proceeding.

The OSBA submitted a Main Brief and Reply Brief in this proceeding on February 25, 2014, and March 12, 2014, respectively.

ALJ Barnes issued a Recommended Decision (“RD”) on June 24, 2014.

³ Peoples/PTWP Statement No. 1-Supp. at 2.

The OSBA submitted Exceptions in response to the RD on July 14, 2014.

Exceptions were also filed by IECPA, Columbia, Penn State, and Peoples.

The OSBA submits the following Reply Exceptions in response to the Exceptions filed by IECPA. Any Exceptions to which the OSBA did not specifically reply should in no way imply agreement with or adoption of those Exceptions.

II. SUMMARY OF REPLY EXCEPTIONS

The OSBA submits these Reply Exceptions primarily in response to the self-serving arguments made by IECPA and Penn State, namely, that the Commission should preserve the *status quo* with respect to the practice commonly referred to as “gas-on-gas competition.” However, the term gas-on-gas “competition” is a misnomer. The appropriate term for the practice is gas-on-gas “price discrimination.” When offering gas-on-gas discounted rates, a natural gas distribution company (“NGDC”) sets 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.

This practice of discounting rates for favored customers is not actual competition. Because it is not competition and does not therefore afford the benefits of competition, gas-on-gas discounting results in discriminatory rates that cannot be justified. Based upon the evidence submitted in this proceeding, it is clear that gas-on-gas discounting is not competition. Competition requires that firms strive to reduce costs in order to reduce prices, improve product quality, and/or improve customer service in order to entice more customers to purchase their products. None of these activities apply in the case of gas-on-gas discounting, wherein NGDCs simply cut prices for certain favored customers and

then recover the foregone revenues by raising prices to their captive customers. Rather, gas-on-gas discounting is simply inequitable price discrimination, where captive ratepayers are forced to pay for the discounts offered to favored ratepayers to keep them from switching to another Pennsylvania NGDC.

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.

If the Commission disagrees with the OSBA that gas-on-gas discounting should be eliminated by phasing it out over a reasonable period of time and determines that gas-on-gas discounting should continue in a modified way, the OSBA believes that the RD was correct in recommending in the alternative adoption of the proposal presented by

Peoples, including the “Potential Acceptable Options” described in Appendix B of Peoples Main Brief.

III. REPLY EXCEPTIONS

1. **Reply Exception to IECPA Exception No. 1: The Recommended Decision erred in concluding that gas-on-gas competition offends public utility law and precedent when, in actuality, gas-on-gas competition is consistent with this authority and presents numerous benefits to customers and NGDCs.**

The RD was absolutely correct to conclude that gas-on-gas competition is inconsistent with public utility law. Setting rates based solely on whether a customer’s location permits it to be served by another NGDC unduly discriminates against customers based on their location, requiring captive customers to subsidize customers with other options. This is the very definition of price discrimination and violates the most basic rate-making principles. Moreover, such discounting presents no net benefits to customers that would justify its continuance. The only benefit is to those large commercial and industrial (“Large C&I”) customers that receive discounts at the expense of captive ratepayers. IECPA’s arguments are a self-serving attempt to maintain the status quo to the detriment of regular ratepayers.

IECPA admits that gas-on-gas competition provides certain Large C&I customers with discounted rates, but denies that these discounts are unreasonable or discriminatory. This position is completely untenable.

As the OSBA explained at p. 16 of its Main Brief, Section 1304 of the Public Utility Code prohibits such discriminatory ratemaking.⁴ As further support, the OCA in

⁴ OSBA Main Brief at 16.

its Main Brief cites to the long history of appellate case law on undue price discrimination, while effectively making the argument that gas-on-gas discounts are undue price discrimination.⁵ The Commission has a valid legal basis and even an obligation to change regulations that currently permit gas-on-gas discounting in violation of the Public Utility Code.

IECPA's argument also ignores the fact that the Commission has already recognized in recent decisions that gas-on-gas discounting is not in the public interest. As I&E and OCA explain in their Main Briefs, there have been multiple Commission decisions that consistently and repeatedly have determined that gas-on-gas competition is harmful and not in the public interest.⁶ Specifically, I&E notes that the Commission has stated that it is "wasteful," "unreasonable," "wholly uneconomic," "poor public policy," and "discriminatory."⁷

IECPA also unconvincingly argues that gas-on-gas discounts do not violate the polestar criterion of ratemaking, cost of service, by citing to Peoples' most recent base rate case where gas-on-gas discounting was permitted, but residential and small commercial customers remitted revenues below their cost of service. IECPA has offered no evidence whether this example is true for any other NGDC. More importantly, even if residential and small commercial rates are set below cost of service at a given point in time, it would necessarily mean that industrial customers with gas-on-gas discounts are being subsidized by industrial customers that do not qualify for a gas-on-gas discount. The cost of the discounted rates must fall on someone, and it is clear that NGDCs are not providing the subsidy.

⁵ OCA Main Brief at 13-17.

⁶ I&E Main Brief at 9-14, OCA Main Brief at 18-20.

⁷ I&E Main Brief at 12.

Unlike IECPA, who does not seem concerned about industrial customers who are not favorably located, the OSBA opposes requiring one set of industrial customers to subsidize another set of industrial customers for no valid economic or policy reason. Moreover, the OSBA is skeptical that IECPA will advocate in the future that all subsidies for gas-on-gas customers must be recovered solely from other industrial customers.

IECPA also argues that gas-on-gas discounts are consistent with other ratemaking principles, especially value of service pricing, *i.e.*, what it takes to keep a customer from switching to another NGDC. Although value of service is the criterion generally cited to allow for discounted rates in competitive circumstances, the OSBA has established that gas-on-gas discounting is not competition.⁸ Moreover, the reason to discount rates in response to competitive alternatives is to preserve the margin earned from competitive customers for the benefit of all ratepayers. However, in the case of gas-on-gas discounting, the net outcome is not a net benefit to all customers, but is in fact a net cost, when viewed from a Commonwealth-wide perspective.⁹ Additionally, IECPA's value-of-service argument relies upon circular reasoning. Of course the rate charged to a gas-on-gas discount customer is based on value of service considerations, because the Commission has permitted these considerations to exist. However, the whole point of this Investigation is to determine whether that type of value of service pricing should be continued and, if so, in what form. The simple fact that gas-on-gas discounting exists is not a valid argument that the status quo should continue.

⁸ OSBA Main Brief at 10-12.

⁹ *Id.* at 12-15; OSBA Reply Brief at 4-7.

2. Reply Exception to IECPA Exception No. 2. The Recommended Decision erred in differentiating gas-on-gas competition from other forms of rate discounting.

The OSBA in its Main Brief at pp. 10-12 explained why gas-on-gas “competition” is not actually competition and therefore is distinguishable from other forms of rate discounting. 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.”¹⁰ 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.¹¹ 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.¹²

Another benefit of actual competition is allocative efficiency.¹³ 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.¹⁴ Once again, this does not apply to gas-on-gas discounting. While customers who are located in overlapping service

¹⁰ OSBA Statement No. 1 at 2-4.

¹¹ *Id.* at 2.

¹² *Id.* at 3.

¹³ *Id.* at 2.

¹⁴ *Id.* at 2.

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.¹⁵ 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.¹⁶

Dynamic efficiency is also a benefit of actual competition.¹⁷ Competition can spur both product and process innovation, thereby reducing prices to consumers over the longer term.¹⁸ 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.¹⁹

Finally, equity is a benefit of actual competition.²⁰ 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

¹⁵ OSBA Statement No. 1 at 3.

¹⁶ *Id.*

¹⁷ *Id.* at 2.

¹⁸ *Id.*

¹⁹ *Id.* at 3.

²⁰ *Id.* at 2.

can be substantially different. Gas-on-gas discounts violate the equity precept that equals be treated equally, and unequals be treated unequally.²¹

Therefore, arguing that gas-on-gas “competition” is actual competition is ignoring basic economic theory and 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.²²

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

Now compare gas-on-gas discounting with flex rates offered in response to *real* competitive threats, *i.e.*, for customers who (a) have interstate pipeline bypass opportunities, (b) have the option to relocate business out of the Commonwealth, (c) offer an attractive economic development opportunity, or (d) have lower cost alternative fuel options (together, “Competitive Options”). Unlike gas-on-gas discounting, flexing rates for customers with Competitive Options can create a net benefit for ratepayers and thus there is an economic justification for this type of price discrimination. Competitive Options, as defined above, equate to real competitive threats that could induce a customer to choose not to be served by *any* Pennsylvania NGDC, unlike gas-on-gas discounts which are offered only to prevent a customer from switching to another Pennsylvania NGDC. Whereas flexing rates for customers with Competitive Options is economically

²¹ OSBA Statement No. 1 at 3.

²² OSBA Statement No. 2 at 6.

justified and therefore is not undue price discrimination, gas-on-gas discounting is undue price discrimination because it does not provide a benefit to the overall Pennsylvania NGDC customer base.

Because flexing rates for customers with Competitive Options can provide a net benefit to ratepayers, the OSBA supports continuation of this important ratemaking technique. However, this Investigation is not and has never been about *real* competitive threats that could induce a customer to choose not to be served by *any* Pennsylvania NGDC. IECPA's reliance on the statutory advocates' endorsement of those instances of flex rates to support its argument that gas-on-gas discounts should also continue is misguided.

3. Reply Exception to IECPA Exception No. 3. The Recommended Decision erred in recommending a transition away from gas-on-gas competition that is unjust, unreasonable, and unworkable.

IECPA argues that any transition away from gas-on-gas discounting which interrupts current customer contracts would be unjust because these contracts were negotiated in good faith and at arms-length. However, captive ratepayers were not included in the "good faith" negotiation of these contracts. 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. 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.

Moreover, NGDCs and flex rate customers should not be rewarded for imprudently entering into unusually long-term flex rate agreements without including provisions in those contracts to protect themselves against a change in regulatory policy.²³ 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.²⁴ The OSBA 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.²⁵ For all of these reasons, abolishing discriminatory rate discounting as soon as is practicable is the only just outcome for this Investigation.

4. Reply Exception to IECPA Exception No. 4. The Recommended Decision erred in recommending Peoples’ proposal as an alternative to *status quo* gas-on-gas competition when no change to *status quo* gas-on-gas competition is warranted.

The RD correctly concludes that there must be a change to *status quo* gas-on-gas competition. The alternative recommendation to adopt the Peoples proposal is a reasonable compromise. By precluding NGDCs from discounting below the full tariff rate of the alternative NGDC, the Peoples proposal essentially ensures that rates will be consistent with at least one NGDC’s costs, and the net Commonwealth-wide subsidy provided by captive customers is essentially eliminated. While the Peoples approach will not encourage NGDCs to be efficient, it will at least eliminate the worst of the rate discrimination and cross-subsidies in the existing rate régime. The OSBA also recognizes that due process may require additional steps in this proceeding, such as, a tentative order or other comment process, but believes that a collaborative process would be unworkable.

²³ OSBA Statement No. 1 at 8.

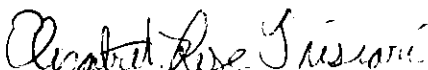
²⁴ OSBA Statement No. 3 at 4.

²⁵ *Id.*

III. CONCLUSION

Wherefore, the OSBA respectfully requests that the Commission issue a statement of policy or order in accordance with the OSBA's recommendations.

Respectfully submitted,



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