

Prepared Testimony of  
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*before the*

Pennsylvania House of Representatives  
Consumer Affairs Committee

Natural Gas Default Service Rates

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## **Introduction**

Chairman Godshall, Chairman Preston, members of the Committee, I appreciate the opportunity to testify on the proposed legislative amendment that would require Natural Gas Distribution Companies (NGDC) to adjust their default service rates on a monthly basis. Because this proposal is still in its early stages, the members of the Pennsylvania Public Utility Commission (PUC) have yet to come to a consensus on whether to support this particular language. Therefore, the testimony that I am about to give today reflects only my position on this issue.

While I am generally supportive of NGDCs adjusting their rates more frequently to accurately reflect the changing cost of natural gas, I would like to hear input and comments from interested parties before reaching a definitive position on the proposed language. As I will explain during my testimony, the PUC has been consistently dedicated to identifying and attempting to remove barriers to a fully competitive natural gas market. This includes the issue of whether the current practice of NGDCs adjusting their rates on a quarterly basis to reflect the cost of gas is sufficient to give customers the proper price signals, or if this approach creates an unlevel playing field for natural gas suppliers trying to enter the competitive market. Given the PUC's history with this issue, it is important that any legislative resolution is well thought out and helps further our collective mission to improve the competitive natural gas market, while also protecting the needs of consumers and NGDCs.

## **Existing Law**

Before describing the PUC's history with this issue, I would like to provide a brief overview of the current law. Section 1307(f)(ii) of Title 66 of the Public Utility Code addresses the recovery of natural gas costs by NGDCs. This section states that a NGDC may adjust its rates for natural gas sales on a regular, but *no more frequently than monthly*, basis to reflect actual or projected changes in natural gas costs reflected in rates, subject to annual reconciliation. Section 1307(f)(ii) further provides that if a NGDC adjusts its rates *more frequently than quarterly*, it shall also offer retail gas customers a fixed-rate option.

The PUC's existing regulations address the frequency of NGDCs' rate adjustments as well. 52 Pa. Code 53.64(i)(5) states that if a NGDC files a tariff reflecting increases in gas costs in accordance with section 1307(f), the NGDC shall make quarterly filings that recalculate its rates to reflect actual gas costs, as well as a reconciliation of prior period over- and under-collections, if the change from the current rate is more than 2 percent.

## **2005 Report to the General Assembly**

In 2005, the PUC submitted a report to the General Assembly assessing the level of competition in the natural gas market five years after the passage of the Natural Gas Choice and Competition Act.<sup>1</sup> This report concluded that that effective competition did not exist in Pennsylvania's retail gas market. In reaching this determination, the report

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<sup>1</sup> *Report to the General Assembly on Competition in Pennsylvania's Retail Natural Gas Supply Market*, from the PUC's Investigation into the Natural Gas Supply Market, Docket No. I-00040103 (Oct. 2005).

examined several potential barriers to market entry for natural gas suppliers, one of which was the quarterly adjustment process under section 1307(f).<sup>2</sup>

The report explained that section 1307(f), which in effect limits NGDCs' rate adjustments to quarterly, creates a lag in recognizing increased gas costs so that customers are unaware of the actual cost of natural gas over the long run.<sup>3</sup> The report found that customers believe to their detriment that the NGDCs are offering a fixed rate when the rate is really a variable cost service with quarterly true-ups. The PUC stated that this system of natural gas pricing makes it difficult for suppliers to compete against the NGDCs for customers.

The report explained that suppliers believe the current law provides NGDCs with an incentive to under-project natural gas costs and place an artificially low annual rate into effect – a rate with which suppliers cannot compete. NGDCs then have the ability to reconcile the artificially low rate through an upward adjustment in the first quarterly filing under 1307(f). The report thus concluded that the way NGDCs adjust their rates to correct over- or under-collections pursuant to section 1307(f) constitutes a barrier to supplier participation and that the adjustment mechanism should be reexamined to encourage increased competition.<sup>4</sup>

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<sup>2</sup> *Id.* at 55.

<sup>3</sup> *Id.* at 60.

<sup>4</sup> *Id.* at 61.

## 2008 SEARCH Report

To address this issue and others identified by the 2005 report, the PUC convened a stakeholder group, known as SEARCH (Stakeholders Exploring Avenues for Removing Competition Hurdles). In 2008, SEARCH issued a report to the PUC discussing possible solutions to the market barriers faced by natural gas suppliers.<sup>5</sup>

The SEARCH report reiterated the PUC's prior finding that suppliers believe eliminating the reconcilable nature of the NGDCs' rates would improve competition by placing NGDC service on the same platform as competitive alternatives.<sup>6</sup> The report stated that suppliers thought the best way to resolve this issue was by either eliminating the adjustment process under 1307(f) or by requiring NGDCs to base their prices on a monthly index, such as the monthly New York Mercantile Exchange (NYMEX), or another financial index.<sup>7</sup> Suppliers argued that under either solution, consumers would receive more accurate price signals and thus would be more likely participate in the competitive market. The report noted that either suggested fix would require statutory changes and revisions to PUC regulations.

The report also mentioned a potential downside to eliminating the 1307(f) reconciliation process or setting NGDCs' prices according to a monthly index. With a monthly market price, natural gas rates will change frequently, meaning consumers will

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<sup>5</sup> *Investigation into the Natural Gas Supply Market: Report on the Stakeholders Working Group*, Docket No. I-00040103F002 (Sept. 2008).

<sup>6</sup> *Id.* at 5.

<sup>7</sup> *Id.* at 3, 5, 6.

feel the price spikes in the market more immediately and significantly than when they are spread over a longer period of time.

### **2008 SEARCH Final Order and Action Plan**

After reviewing the findings in the SEARCH report, the PUC issued a Final Order and Action Plan on September 11, 2008.<sup>8</sup> In this order, the PUC concluded that it was necessary to rework NGDCs' default service rate, also known as the Price to Compare, to attract suppliers and increase effective competition in the retail natural gas supply market. The PUC therefore initiated a rulemaking to reformulate the Price to Compare, including the method for adjusting the rate to account for the fluctuation in gas costs.

### **Price to Compare Rulemaking**

Consistent with the Final Order and Action Plan, the PUC issued a Final Rulemaking Order reformulating the Price to Compare on June 23, 2011.<sup>9</sup> In this order, the PUC considered, among other things, requiring monthly adjustments to the Price to Compare. However, the PUC ultimately decided not to pursue that option.

In reaching this conclusion, the PUC explained that NGDC rates are based on least-cost purchasing practices that include a mix of short and longer term contracts for default supply and include positive and negative reconciliation adjustments. Given this, the PUC determined that mandating monthly adjustments to the Price to Compare would not result in rates that are materially closer to spot market prices. The PUC explained

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<sup>8</sup> *Final Order and Action Plan*, Docket No. I-00040103F002 (Sept. 11, 2008).

<sup>9</sup> *Revised Final Rulemaking Order*, Docket No. L-2008-2069114 (June 23, 2011).

that the purchased gas cost does not represent current wholesale prices and requiring monthly adjustments will not alter this fact. Consequently, the PUC found that quarterly rate adjustments are adequate to reflect changes in market rates over time.<sup>10</sup>

The PUC further reasoned that the continuing use of quarterly adjustments would avoid the complex issue of requiring NGDCs to offer a fixed rate option. As explained earlier, the current law states that NGDCs may not adjust their rates more frequently than quarterly unless the NGDC also offers a fixed-rate option. Requiring NGDCs to provide such an option is complicated because doing so would likely undermine the purpose of requiring more frequent rate adjustments. Rather than encouraging competition by exposing customers to the actual price fluctuations of natural gas, it is likely customers would simply choose the stability of a fixed rate option. Thus, PUC ultimately decided not to require monthly adjustments in the rulemaking.

However, the PUC did express concern about the large positive or negative reconciliation adjustments some customers have experienced when switching to an alternative supplier, also known as migration riders. As a partial remedy to this, the PUC reasoned that NGDCs' migration riders should be consistent with their 90-day reconciliation adjustments. Accordingly, the PUC invited the NGDCs to file shortened migration riders (i.e., a 90-day rider, as opposed to an annual migration rider) so that customers will not be burdened by paying for out-of-date and prior period natural gas costs.

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<sup>10</sup> *Id.* at 25-28.

The Final Rulemaking Order is currently pending approval before the Independent Regulatory Review Commission (IRRC).<sup>11</sup>

### **Proposed Amendment**

As this brief history demonstrates, the PUC has taken clear steps to foster and encourage a fully competitive natural gas market in Pennsylvania. However, a truly competitive market is unlikely to exist unless consumers are exposed to the actual cost of natural gas and suppliers can compete on a level ground with NGDCs. One way to do this is to require NGDCs to adjust their rates more frequently than quarterly to reflect the cost of natural gas. Because I believe this change would help to improve Pennsylvania's competitive natural gas market, I am generally supportive of the idea behind the proposed legislative amendment.

The PUC's recent decision in the Rulemaking to maintain quarterly reconciliations instead of monthly was in large part because the PUC was working within the bounds of the existing law. However, amending the law to allow the PUC to require NGDCs to adjust their rates more frequently would without a doubt be an effective tool for the PUC to use to promote natural gas competition. As my earlier discussion demonstrated, NGDCs' use of quarterly rate changes have inhibited them from responding to changes in gas costs, thus causing significant imbalances, high consumer interest costs, and inaccurate price signals to customers with regard to natural gas shopping. Furthermore,

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<sup>11</sup> The PUC submitted the Final Rulemaking Order to IRCC on June 24, 2011. On September 12, 2011, IRCC issued an order informing the PUC that it had disapproved the final-firm regulation and the PUC had 40 days to submit a response. The PUC submitted a response to IRCC on October 13, 2011.

utilities with particularly large imbalances have been forced to make a one-time, interim price change, which certainly is not an ideal solution.

The PUC remains committed to achieving the most successful and fully competitive natural gas market possible in Pennsylvania. I believe the legislative amendment that is the subject of today's hearing is a step in the right direction. However, given the preliminary nature of this proposal, I would like to hear from NGDCs, customer advocates, and suppliers in more detail before taking a final position on the specifics of this draft.

Thank you again for the opportunity to speak to you about this important issue. I am happy to answer any questions you may have.

