

BEFORE THE PENNSYLVANIA HOUSE CONSUMER AFFAIRS COMMITTEE

Testimony of

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**Informational Meeting on the
State of Retail Competition in the
Natural Gas Industry**

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Good Morning Chairman Godshall, Chairman Preston and members of the Committee. I am Terry Fitzpatrick, President and CEO of the Energy Association of Pennsylvania, a trade association whose members include electric and natural gas utilities operating in Pennsylvania. Thank you for this opportunity to present comments on the state of competition in Pennsylvania's natural gas retail market. To summarize, I will provide a brief history of Gas Choice; advise that additional legislative or regulatory changes other than those already approved are not necessary to further promote gas competition at this time; and advocate focusing on the potential impacts to customers arising out of proposed legislative, regulatory and policy changes that could increase costs and/or create customer confusion.

Background

Prior to changes in federal policies in the 1980s and 1990s, interstate natural gas pipelines purchased gas at regulated rates from producers, combined those costs with their costs of transporting gas to market areas, and then sold gas at regulated rates to natural gas distribution companies ("NGDCs"). NGDCs, in turn, recovered associated costs through uniform purchased gas cost rates that did not vary based on customer usage characteristics. As a consequence of natural gas "shortages" experienced in the 1970s under price regulation, first the price paid to producers for natural gas was deregulated, and then interstate pipeline and storage systems were required to provide transportation and storage services for third party transporters to permit the delivery of gas supplies to markets. Later, interstate pipelines became open access carriers that only transport and store gas at rates subject to FERC regulation. Under such regulation, the prices paid for natural gas transportation or storage services are often paid in the form of so-called demand charges that do not vary significantly based on the amount of gas transported.

As a result of these changes at the federal level, in the 1990s Pennsylvania NGDCs no longer purchased gas from interstate pipelines, and instead began to purchase transportation and storage services and bought gas on the open market for their customers. They also continued to recover all associated costs through uniform volumetric purchased gas costs ("PGC") rates despite the varying usage characteristics of their customers. This was viewed by many large volume customers as unfair since

the volumetric PGC rates they paid included demand charges incurred for capacity used to serve low volume, primarily seasonal, loads of residential and other small customers. To address these concerns, retail transportation service was initiated for larger customers in the early 1990s, and most large volume customers began to acquire their own gas supplies. Since such large volume customers could recover the relatively fixed demand costs for transportation and storage services used to serve them over larger volumes than a low volume seasonal customer, such as a residential heating customers, they could experience a lower per unit rate than volumetric PGC rates, even if they purchased transportation and storage services and gas supplies at the same rates as NGDCs serving low volume residential customers with seasonal heating loads. Accordingly, most large volume customer loads migrated to transportation service in the 1990s before the adoption of retail choice legislation in Pennsylvania, and the PGC primarily served residential and small volume customer loads. Under state tax policies in effect at the time, such transportation customers also experienced a tax break since gross receipts taxes were not assessed on transportation service, but were assessed on PGC service.

Seeking to expand competition beyond high volume customers, the Pennsylvania Public Utility Commission (“PUC” or “Commission”) approved retail choice pilot programs in 1996 for approximately 25,000 residential and small commercial customers of Columbia Gas of Pennsylvania and Equitable Gas Company. In 1997, the PUC approved the implementation of customer choice pilot programs for three additional natural gas utilities, PG Energy, Inc. (now UGI Penn Natural Gas, Inc.), National Fuel Gas Distribution Corp and People’s Natural Gas Company. In 1999, the Pennsylvania General Assembly enacted the Natural Gas Choice and Competition Act (“Choice Act”) which restructured the natural gas industry statewide, enabling the majority of residential and small commercial customers to choose their own gas supplier. In conjunction with the Choice Act, the gross receipts tax levy was removed from customers receiving PGC service, thereby equalizing the tax treatment of transportation and PGC service, but removing an incentive that had perhaps spurred interest in retail choice pilots.

With the adoption of the Choice Act, the General Assembly established a framework of rules that permitted licensed natural gas suppliers to offer natural gas supply services to all retail gas customers. Concurrently, the Choice Act encompassed a policy decision whereby the NGDC retained a role as the “supplier of last resort” (“SOLR”) for customers that did not choose an alternate supplier or who were rejected or otherwise no longer served by an alternate supplier. The statute provided that the NGDC could relinquish its role as the SOLR only to another entity approved by the Commission. The General Assembly further made a policy decision to essentially retain the existing PGC mechanism¹ to govern the recovery of costs attributable to those SOLR obligations. The legislation did provide for some changes to the PGC mechanism to permit more frequent adjustments to PGC rates to minimize the impact of subsequent reconciliations which could cause PGC rates to diverge from then existing market conditions.

For example, prior to implementation of the Choice Act, NGDCs could propose a change to the PGC rate once per year with certain exceptions established through regulation. During an annual filing process, over or under recoveries would be determined, and either refunded to or collected from customers through an E-factor adjustment to the PGC rate established for the subsequent annual period. The Choice Act authorized NGDCs to reconcile the PGC rate on a more frequent basis to potentially minimize E-factor adjustments. If the adjustment was to occur more frequently than quarterly, the NGDC was also required to “offer retail gas customers a fixed-rate option which recovers natural gas costs over a twelve-month period, subject to annual reconciliation....” 66 Pa. C.S. §1307(f)(1)(ii). Mandating the fixed-rate option, if the NGDC chose to adjust the PGC more frequently than quarterly, reflected a policy determination to favor customer preference for stable prices over the supplier desire that NGDC retail rates be adjusted more frequently, which it was argued would result in PGC rates that more accurately reflect current wholesale prices.²

¹ PGC rates are designed to recover natural gas costs as defined in the Public Utility Code on a dollar-for-dollar basis. Since (a) wholesale gas costs can change quite frequently and unpredictably, (b) demand levels can change because of weather and other conditions that also cannot be predicted in advance, and (c) PGC rates are reconcilable pass-through rates that allow for cost variations, PGC rates must be adjusted periodically to reflect changes in the amount to be recovered.

² In reality, however, since PGC supplies are often bought in advance, more frequent reconciliations do not necessarily result in PGC rates reflective of current wholesale prices but do provide a means to reduce the size of E-factor adjustments.

Results of PUC Investigation and Report to the General Assembly

Recognizing the breadth of the changes to be implemented, the Choice Act directed the PUC to conduct an investigation five years following the effective date of the legislation “to determine whether effective competition for natural gas supply exists on the natural gas distribution companies’ systems in...[the] Commonwealth.” Section 2204(g) of the Public Utility Code, 66 Pa. C.S. §2204(g). The PUC initiated an investigation by Order entered on May 28, 2004, and subsequently issued a Report to the General Assembly on October 6, 2005, concluding that “effective competition” did not exist.

The Commission determined that “effective competition” in the retail natural gas supply market could be demonstrated “by participation in the market by many buyers and sellers, the lack of substantial barriers that would discourage customer participation and the presence of sellers offering buyers a variety of products and services.” Report at p. 1. Having concluded that “effective competition” did not exist in the retail or choice market, the Commission reconvened “the stakeholders in the natural gas industry in this Commonwealth to explore avenues, including legislation, for encouraging increased competition....” *Id.* The reconvened stakeholder working group, known as S.E.A.R.C.H., met throughout 2006 and compiled a report which summarized various positions, focusing primarily on barriers to market entry which had been identified by natural gas suppliers.

In September of 2008, the Commission adopted the S.E.A.R.C.H. Report, released it to the public and established an Action Plan “to reduce barriers to entry and to change the structure and operation of the retail market in order to increase competition in natural gas supply.” *Investigation into the Natural Gas Supply Market: Report of Stakeholders’ Working Group (SEARCH); Action Plan for Increasing Effective Competition in Pennsylvania’s Retail Natural Gas Supply Services Market, Docket No. I-00040103F0002, Final Order and Action Plan entered September 11, 2008 at p. 5.* The Commission determined that its Action Plan would be implemented in two phases.

The first phase created an Office of Competitive Market Oversight within the PUC to provide an informal forum for resolving disputes between NGDCs and natural gas suppliers/marketers, developed guidelines for the expansion of purchase of receivable

programs (“POR”) and further considered the need for legislative changes regarding capacity assignment and release.

In the second phase, the Commission identified matters best implemented by means of rulemakings and proposed three separate rulemakings, each addressing separate groups of issues. The first rulemaking, which was proposed in December 2008 and became effective in January 2011, established new regulations regarding marketer licensing. Issues pertaining to supplier creditworthiness, reasonable security requirements and use of accounts receivable as collateral, all of which had been identified as barriers by suppliers, were addressed in that proceeding.

The second rulemaking, which was proposed in March 2009 and is currently pending before the Independent Regulatory Review Commission, establishes regulations concerning (1) the reformulation of the “price to compare” used by customers to compare the retail rate offered by the NGDC with the price offering of the natural gas supplier; (2) purchase of receivable programs; and (3) the release, assignment or transfer of pipeline and storage capacity associated with customers served by natural gas suppliers.

The third rulemaking, which was proposed in April 2009, identifies and addresses a common set of business practices for implementation by NGDCs which purportedly will increase market participation by suppliers in Pennsylvania’s retail gas market. This rulemaking provides for standardizing coordination tariffs and implementing standard practices regarding imbalance trading, tolerance bands, cash out/penalties, and nominations and delivery requirements. A sub- group to develop and implement communication standards for use by NGDCs and suppliers is also part of this third rulemaking.

Finally, in the *Final Order and Action Plan*, the Commission accepted the recommendation of the stakeholder working group to conduct a formal milestone review to evaluate progress in developing more competition in the retail market for natural gas supply and determined that such a review would “be due five years from the entry date of this order.” *Final Order and Action Plan at p. 7.*

EAP notes that while the Commission initially determined to complete this review by September of 2013, it may be prudent to conduct the review a sufficient period of time following the approval or disapproval of all three sets of rulemaking so as to assess

the impact of those changes on the natural gas retail market. Moreover, EAP believes that any additional review should also include an analysis from the customer perspective, i.e. are there barriers which prohibit greater participation by customers in the market and, for those customers participating, are the benefits cost effective.³ In this regard, EAP respectfully submits that it is perhaps not surprising that residential small volume heating customers have not found transportation service to be as compelling a value as large volume customers, since the demand costs of the transportation and storage services acquired to meet their needs must be recovered over their smaller seasonal volumes whether the service is provided by a natural gas supplier or a NGDC. Stated another way, it is federal policies governing the pricing of transportation and storage services, and the economics of recovering fixed costs over larger and smaller volumes, that is probably the chief barrier to making transportation as compelling a choice for small volume heating customers, and not supposed “barriers to competition.” It should also be noted that the benefits of open and robust markets for natural gas, as well as FERC-regulated natural gas transportation and storage rates and policies, currently benefit all Pennsylvania consumers since NGDCs in purchasing gas for PGC customers and natural gas suppliers purchasing gas for their customers acquire gas in the same market and are subject to the same FERC-regulated gas transportation and storage rates, rules and policies.

Shopping Statistics

To evaluate the level of retail shopping in Pennsylvania, a good starting point is the quarterly shopping statistics maintained on the website of the Office of Consumer Advocate (“OCA”).⁴ These statistics have been maintained since October 2001, and are limited to residential customers of the major regulated NGDCs in the Commonwealth.⁵

³ See National Regulatory Research Institute Report, “*Gas Choice: Do Residential Customers Benefit?*”, July 2011 at http://www.nrri.org/pubs/gas/NRRI_Gas_Choice_July11-14.pdf.

⁴ www.oca.state.pa.us

⁵ While shopping statistics for commercial/industrial natural gas customers have not been maintained by OCA, some information can be gleaned from limited data on the website of the U.S. Energy Information Administration and from historical data maintained by some NGDCs with regard to non-residential customers who receive transportation service only, i.e. shop, from the gas utility. A quick review of limited information demonstrates that most high use non-residential customers are served by alternative gas suppliers and that the gas supply served by alternate suppliers represents a large percentage of through-put for the NGDC in those customer segments.

An examination of the statistics reveals (1) that from October 2001 through the present, natural gas suppliers have maintained residential customers in the service territories of Columbia Gas of Pennsylvania, Equitable Gas, Peoples Natural Gas Company and PECO; (2) that beginning in October 2002, natural gas suppliers also had residential customers in the UGI Utilities, Inc. - Gas Division service territory; and (3) that in October 2010, more natural gas suppliers began actively supplying residential customers in the UGI Penn and National Fuel Gas service territories. The percentage of residential customers served by alternate natural gas suppliers statewide has ranged from roughly 6% to 13% during the time period in which OCA maintained statistics, with the highest percentage served occurring in 2001. Additionally, the percentage of residential customers using alternate suppliers in the service territories of Columbia Gas, Peoples and Equitable has remained relatively stable throughout this time period with each of these NGDCs having participated in pilot programs prior to enactment of the Choice Act.

National Fuel Gas, which also offered a pilot program in 1997, did not experience any meaningful shopping among its residential customers until the early fall of 2010. It had instituted a purchase of receivables program with PUC approval in July 2010 which may explain the increase in supplier marketing activities and customer shopping in their service territory. On the other hand, Peoples Natural Gas has maintained the highest percentage of shopping among its residential customers beginning in October 2001 (approximately 28%) even though it never had a purchase of receivables program. The Commission recently approved a POR program for Peoples which will not be implemented until January 2012. Similarly, alternate suppliers have served residential customers in the Equitable service territory since 1996 without a purchase of receivables program in place. Viewing all of this experience, it is difficult at this stage to draw firm conclusions about the importance of POR programs to stimulating shopping.

Additional Regulations and Legislation

Pennsylvania's NGDCs support choice programs and have been active participants in the investigations conducted and working groups formed by the Commission to examine the effectiveness of competition in the natural gas supply market. As described above, the Commission is currently implementing a Final Order

and Action Plan aimed at increasing competition in the natural gas supply market, including the drafting and approval of three separate sets of regulations dealing with issues identified primarily by suppliers as barriers to market entry.

Given the fact that the PUC is currently working with various stakeholders, including NGDCs, suppliers and consumer advocates, to develop effective competition in this market, the Association does not support additional legislative changes at this point. Additionally, EAP has concerns about at least one of the pending PUC rulemakings. The final form regulation regarding NGDCs and the Promotion of Competitive Retail Markets that is scheduled for review by the Independent Regulatory Review Commission at its August 11th meeting represents an attempt by the PUC to implement regulatory changes that it believes will help promote gas competition in Pennsylvania. The EAP agrees that some of the proposed changes may improve gas competition. However, stakeholders continue to be divided regarding what costs should be included in the price to compare. Specifically, contrary to the comments of various NGDCs, the EAP, and the Office of Consumer Advocate, the proposed rule would require NGDCs to include all of their supplier of last resort (“SOLR”) costs in the price to compare. Our concern is that unavoidable costs related to gas procurement will be included in the price to compare to the detriment of non-shopping customers, who we believe will be subsidizing shopping customers. The unbundling required by the rulemaking may result in stranded costs in the future contrary to the Choice Act. The EAP continues to underscore that the risk of future stranded costs can be eliminated if unavoidable procurement costs remain in base rates and are paid for by both shopping and non-shopping customers. Including these unavoidable procurement costs and the E-factor in the price to compare thwarts the expressed policy objective of providing consumers with the ability to make an “apples to apples” comparison between the commodity price offered by the utility and a supplier. Inflating the regulated utility’s price as compared to the unregulated supply price by inappropriately adding costs that should be paid by both shopping and non-shopping customers is not a suitable way to increase competition within the Commonwealth.

Based upon the above concerns, EAP recommends that regulations that have not been fully promulgated and any newly proposed regulations, legislation or policy changes should be delayed for a reasonable period of time in order to allow the natural

gas competition market to mature as a result of the recent changes it has experienced including an upsurge in purchase of receivable programs and an increase in natural gas suppliers. Regulatory and legislative changes can lead to costly program implementation by utilities and customers ultimately bear those costs.

In addition, it is recommended that the initiation of any second formal review of natural gas supply competition in Pennsylvania by the PUC begin following a reasonable period of time after the anticipated regulations are approved or disapproved so as to evaluate not only the impact on barriers identified by suppliers but the impact on customers, particularly as it regards benefits and cost-effectiveness.

Finally, EAP suggests that the impact on customers should be the focus and primary reason for future regulatory or legislative changes to gas competition in Pennsylvania. Policy makers should take a balanced view of the realities of the retail choice market, and recognize that there may simply not be as compelling a business model for success in serving small retail customers as there was in serving large volume customers moving from PGC rates that contained an inherent cross-subsidization of small volume customers. This economic reality should not trigger efforts to make PGC rates unstable or overly complicated for residential and small volume customers, since in the end such efforts are likely to place natural gas service, one of the most environmentally beneficial fuels and an energy source now produced in great volumes in Pennsylvania to the benefit of all the Commonwealth's citizens, at a competitive disadvantage to other less energy efficient and environmentally beneficial energy sources to the detriment of NGDCs and natural gas suppliers alike.

Thank you for providing me the opportunity to offer comments and I welcome the chance to answer any questions and to continue to work with all stakeholders to improve competition in the natural gas supply market in Pennsylvania.