STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 93-G-0932 - Proceeding on Motion of the Commission to Address Issues Associated with the Restructuring of the Emerging Competitive Natural Gas Market.

CASE 97-G-1380 - In the Matter of Issues Associated with the Future of the Natural Gas Industry and the Role of Local Gas Distribution Companies.

POLICY STATEMENT CONCERNING THE FUTURE OF THE NATURAL GAS INDUSTRY IN NEW YORK STATE AND ORDER TERMINATING CAPACITY ASSIGNMENT

Issued and Effective: November 3, 1998

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a session of the Public Service Commission held in the City of Albany on October 7, 1998

COMMISSIONERS PRESENT:

Maureen O. Helmer, Chairman
John B. Daly
Thomas J. Dunleavy
James D. Bennett

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(Issued and Effective November 3, 1998)

BY THE COMMISSION:

The natural gas industry has undergone continuous and dramatic change over the last decade. Within New York, retail competition began in the mid-1980s when large customers were given the option to purchase gas directly. Since then, we have required that local gas distribution companies (LDCs) unbundle their tariffs and provide for small customer aggregation programs.[1/] At the same time, we allowed LDCs to assign a pro rata share of capacity to customers migrating from sales to transportation service during the three year period ending March 31, 1999.

[1/] Case 93-G-0932, Restructuring of the Emerging Competitive Natural Gas Market, Order Concerning Compliance Filings (issued March 28, 1996).

On September 4, 1997, we issued for comment a staff study which concluded that the most effective way to establish a robust competitive market for gas supply is for LDCs to exit the merchant function, that is, to cease selling gas over a five year period. Comments were received from a broad range of parties.

This Policy Statement announces our view on how best to ensure a competitive market for natural gas in New York. The concomitant order requires that local distribution companies cease assigning capacity to migrating customers no later than April 1, 1999.

OVERVIEW OF COMMENTS

The key issues raised by the parties[1] concern staff's conclusion that LDCs should exit the merchant function. About half of the 35 parties responding support staff and another one-third take no position. Most LDCs either support or do not oppose, in principle, exiting the merchant function. A few LDCs either oppose a mandate to exit or believe such action is premature. The following specific concerns were raised:

Transition Period - Gas marketers generally believe that a five year transition period is too long. A few parties believe that five years is too short to harmonize properly the exiting of the merchant function with capacity contract expiration schedules and minimize strandable costs.

Need for Commission Action - Some parties with opposing views on exiting the merchant function believe we should not "force" a new framework on a non-accepting public. They argue that small customers are not interested in choosing a gas supplier, that marketers are not interested because the profit margins are too thin, and that requiring LDCs to exit the merchant function is contrary to customer choice. However, one

[1] The Report and Recommendation of Department of Public Service Staff contains a summary of the comments and staff's recommendations. It may be obtained from our Filing Services Unit or from our web site (dps.state.ny.us, go to File Room, and search our data base under Staff Reports).

marketer offered an opposing view, that without Commission action marketer penetration will stagnate at three to five percent of the total market.

Provider of Last Resort (POLR) - Several parties believe that the Public Service Law and the Transportation Corporations Law require that LDCs continue to sell gas. Some LDCs believe resolution of these issues is a prerequisite to any reductions in pipeline capacity assets.

Reliability - Several LDCs object strongly to reliance on the market to assure system reliability. Specific concerns relate to maintaining the ability to meet statutory service obligations and to ensuring that capacity remains dedicated to New York State.

Capacity Auctions - There was no support for capacity auctions.[1/] The existing secondary capacity market established under Federal Energy Regulatory Commission (FERC) rules was identified as the "official" auction process[2/]. Parties argued that this process cannot provide true market prices because FERC rules limit the price for capacity to the maximum tariff rate. Another concern is that statewide auctions will create a buyers' market and lower the value of capacity.

Cost Recovery - LDCs believe that they are entitled to full recovery of both strandable costs and costs required to implement the overall program.

STATEMENT OF VISION

We intend to facilitate development of a competitive market; eliminate barriers to competition; provide guidance to LDCs and marketers, especially with regard to expiring capacity

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[1/] Comments were provided before the auction concept for electric generation was embraced. Parties' views may be different today.

[2/] FERC recently proposed revisions to its capacity release rules. (Notice of Proposed Rulemaking on Regulation of Short-Term Natural Gas Services, Docket No. RM98-10-000, issued July 29, 1998, 63 Fed.Reg. 42,982).

contracts; and address customer inertia. It appears that with few exceptions, LDCs have adopted a passive, "let the market develop naturally" approach to competition in gas supply.

Our vision for the future of the natural gas industry in New York in an increasingly competitive market includes these goals:

(1) Effective competition in the gas supply market for retail customers;

(2) Downward pressure on customer gas prices;

(3) Increased customer choice of gas suppliers and service options;

(4) A provider of last resort;

(5) Continuation of reliable service and maintenance of operations procedures that treat all participants fairly;

(6) Sufficient and accurate information for customers to use in making informed decisions;

(7) The availability of information that permits adequate oversight of the market to ensure its fair operation; and,

(8) Coordination of Federal and State policies affecting gas supply and distribution in New York State.

DISCUSSION

Competition and Customer Choice

The most effective way to establish a competitive market in gas supply is for local distribution companies to cease selling gas. Without separation of the monopoly gas distribution function and the competitive merchant function the LDCs would likely remain dominant providers. The elimination of regulated LDC merchants would also address "level playing field" issues between LDCs and marketers. Thus, separation of the LDC distribution function from the competitive merchant function would maximize competition and customer benefits. Additionally, the regulation of a competitive function should be unnecessary.

Customers who have already migrated to alternative suppliers are generally enjoying service and pricing options not available from utilities. In addition, an enhanced competitive environment will exert general downward pressure on costs of all elements of utility service and yield synergy savings through the provision of a combination of services (e.g., gas, electric, telephone) through one supplier. While upward cost pressure may be felt by some customer groups as subsidies are eliminated, the overall impact is expected to be a general reduction in prices.

Although the exit of an LDC from the merchant business would reduce the choice of available gas suppliers by one, that action is preferable to the potential competitive harm in having a regulated LDC continuing to dominate the supplier function. If an LDC transition out of the merchant business is properly made, the result will be more choice for customers, not less.

Provider of Last Resort

We will continue to safeguard customers. LDCs will continue to be the provider of last resort for gas service, at least for the short term while other options are more fully explored and developed by staff and interested parties. Such options should be explored and resolved collaboratively, to the extent possible, in connection with POLR issues in the electric restructuring proceedings.

Reliability

No compromise in system reliability will be permitted. We take very seriously the issues raised regarding system reliability. An exit of the LDCs from the merchant function will not be allowed until we are assured that continued reliability is assured and that gas will be available to firm customers at all times. Toward that end, LDCs will continue to be the system operators and will be allowed to maintain access to sufficient assets (e.g., gas supply, pipeline and storage capacities) to assure proper operation of the system. LDCs may impose reasonable requirements on marketers to assure such proper operation.

Additional issues must be addressed as we move forward in a more competitive environment. As the proportion of upstream capacity controlled by LDCs diminishes and the number and market share of merchants increases, the operation of the distribution systems is likely to change. The LDCs, marketers and pipelines know the operation of the gas systems and are best positioned to offer alternatives for addressing these issues. Further, operating procedures must not only ensure reliability, but also be transparent and treat all participants fairly. In addition, we must be assured that there are transportation routes from the production area to the city gate such that gas will be delivered when needed. We believe a collaborative process including all stakeholders is an appropriate process to address reliability of gas supply to New York consumers. We expect an orderly migration that will not overwhelm LDCs' systems and we will monitor developments closely to ensure that it is taking place.

Customer Education

Enhanced customer education is needed to facilitate the transition to a competitive market. Customers need information on the changes in the industry and marketers offering services, as well as guidance on how to evaluate various offers. LDCs must provide customer education as long as they are in the merchant business. In addition, customer education will help to address customer inertia.

Market Power

Natural gas market power issues will arise and must be addressed. We have already issued guidelines on horizontal[1/]

[1/] See, e.g., Case 96-E-0900, Orange & Rockland Utilities, Inc., Order Authorizing the Process for Auctioning of Generation Plan and Rejecting Joint Agreement, (issued April 16, 1998. Appendix A.

and vertical market power[1] for electric utilities. While market power issues also arise for natural gas, some of the particular circumstances are different and must be carefully monitored and addressed as the transition to a competitive environment proceeds.

Relationship to Federal Policies

State unbundling efforts cannot succeed without complementary federal policies. FERC rules and policies will have direct financial and operational impacts on the interstate pipeline companies on which New York depends for delivery of its gas supply. FERC has recently issued a Notice of Proposed Rulemaking addressing short-term capacity transactions.[2] FERC's final rule may have implications that require us to re-examine some issues in our proceedings. Continuous monitoring of Federal policies, collaboration with FERC as appropriate, and our active intervention in FERC proceedings will be required to assure the success of our competitive policies.

TRANSITION PROCESS

We envision a process comprising three basic elements which should be pursued in parallel. The first consists of discussions with each LDC on an individualized plan that would effectuate our vision. Discussions should take into account statutory requirements and the needs of each LDC, including capacity contract expiration schedules, a rate plan (either existing or to be developed), the state of market development, and other relevant factors, with a transitional time frame of three to seven years. Staff should also discuss with each LDC a

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[1] See, e.g., Cases 96-E-0900 et. al., Orange & Rockland Utilities, Inc., Statement of Policy Regarding Vertical Market Power (issued July 17, 1998).

[2] Notice of Proposed Rulemaking on Regulation of Short-Term Natural Gas Services, Docket No. RM98-10-000, issued July 29, 1998, 63 Fed.Reg. 42,982.

schedule for initiation of negotiations and should provide a status report to us after those initial discussions.

In preparation for negotiations, LDCs shall address the following issues in a proposal to be distributed to interested parties thirty days before the start of negotiations:

(1) A strategy to hold new capacity contracts to a minimum;

(2) A quantification of potential stranded costs and a plan to mitigate and manage them;[1/]

(3) A long term rate plan with a goal of reducing or freezing rates;

(4) A plan to further unbundle rates which would:

 (i) separate distribution and gas purchase (upstream) costs;

 (ii) separately identify distribution cost elements;

 (iii) identify changes which would promote retail competition;

 (iv) propose other rate design changes, if appropriate.

(5) A plan to enhance consumer education programs and facilitate customer participation;

(6) The possibility of a more aggressive role for LDCs in facilitating the move to a competitive market.

The second element consists of collaboration among staff, LDCs, marketers, pipelines, and other stakeholders on a number of key generic issues.

[1/] At a minimum, the LDC must demonstrate that it has made reasonable efforts to minimize strandable costs in compliance with the Commission's directives in Case 93-G-0932, including the requirements of the Order Clarifying the April 1998 Excess Capacity Filing Requirements, issued September 4, 1997.

(1) Staff, LDCs, marketers, and other stakeholders should examine and address future system operation and reliability issues through development of appropriate procedures, protocols, and information systems, and provide a status report to the Commission as of April 1, 1999. We welcome the advice and expertise of the interstate pipeline companies in our process.

(2) Staff, LDCs, marketers, and other stakeholders should examine and develop safeguards and monitoring mechanisms for market power issues in natural gas markets, particularly in light of the LDCs' exiting the merchant function, with a status report to the Commission as of April 1, 1999.

The third element addresses coordination of issues that are also faced by electric utilities. This includes provider of last resort issues, as well as a plan to allow competition in other areas, such as metering, billing, and information services. These issues should be addressed in conjunction with the electric restructuring proceedings.

STATE ENVIRONMENTAL QUALITY REVIEW ACT

We have conducted an analysis under the State Environmental Quality Review Act and have determined that there will be no significant environmental impact from adoption of this Policy Statement and therefore we have issued a Notice of Determination of Non-Significance.

The LDCs shall submit draft environmental assessment forms with their individual proposals.

TERMINATING CAPACITY ASSIGNMENT

As part of our restructuring of the gas industry, we allowed LDCs to require customers migrating from sales to transportation service (i.e., those customers getting gas from someone other than a regulated utility) to continue their responsibility for upstream capacity for three years:[1/]

[1/] Case 93-G-0932, Restructuring of the Emerging Competitive Natural Gas Market, Order Concerning Compliance Filings (issued March 28, 1996), p.7, Order Resolving Petition for Rehearing (issued September 13, 1996), p.4.

> We find a need to provide a transition into an unbundled environment and will allow LDCs to require converting customers to take associated capacity for a three year period beginning with the effective date of this Order or until such time as a utility contracts for additional capacity or an existing contract expires, whichever occurs first. Prior to the start of the third year [(by April, 1998)] we will require that each utility demonstrate its efforts taken to relieve itself of "excess" capacity. We will address any issue of stranded cost then.[1/]

The three year transition period was established in recognition of the LDCs' long term contracts for interstate pipeline capacity and that some of that capacity could potentially become stranded if converting customers were not required to use it. During the three year period, the assignment of capacity would avoid the creation of stranded costs. However, such assignment would also limit the ability of marketers to find and use cheaper capacity and prevent customers from realizing savings.

In September 1997, we explained further our views on the utility obligations to shed excess capacity and specified actions that needed to be taken to mitigate strandable costs and to plan for competition.[2/]

To continue the movement to a competitive gas supply market, LDCs may no longer require capacity assignment or inclusion of capacity costs in transportation rates beyond

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[1/] Ibid., Order Resolving Petition for Rehearing, p.9.

[2/] Case 93-G-0932, Proceeding on Motion of the Commission to Address Issues Associated with the Restructuring of the Emerging Competitive Natural Gas Market, Order Clarifying April 1998 Excess Capacity Filing Requirement, (issued September 4, 1997). Utility filings discussing the excess capacity issue have been summarized by staff in Summary of LDC 1998 "Excess Capacity" Filings. The summary is available from our Filing Services Unit or our web site (dps.state.ny.us, go to File Room, and search our data base under Staff Reports), as is Staff Discussion of Strandable Costs.

April 1, 1999 to customers migrating to marketers except where specific operational and reliability requirements warrant.[1] Where an LDC believes such circumstances continue to warrant capacity assignment, it will be required to make such a showing. LDCs seeking to assign capacity shall file a request to do so within 60 days of the date of this order with a copy to each marketer eligible to provide service on its system. New[2] capacity contracts should be held to the absolute minimum necessary for system operation and reliability purposes. Where new capacity is needed LDCs should take actions designed to minimize stranded costs such as encouraging marketers to provide capacity, or if the LDC must acquire capacity, shifting to reliance on short-term and citygate arrangements.

Additionally, effective April 1, 1999, the sharing of released capacity revenues for the capacity no longer assigned to migrating customers will be eliminated and LDCs will be provided a reasonable opportunity to recover strandable capacity costs[3] as discussed below.[4] We will revisit the mechanism for recovery of stranded costs when a company's level of migration approaches 10 percent of its peak day upstream capacity or in the individual LDC discussions, whichever comes first.

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[1] LDCs with intermediate pipelines -- a pipeline between the local distribution system and an interstate long-haul pipeline -- could present unique cost and reliability issues which require further consideration.

[2] "New" refers to both the renewal of expiring contracts as well as entering into contracts for additional capacity.

[3] We do not reach here the recovery method for other costs resulting from restructuring.

[4] Separately, Multiple Intervenors has petitioned for rehearing of our order authorizing Corning Natural Gas Corporation and Orange and Rockland Utilities, Inc. to recover some strandable capacity costs, arising from a pilot non-assignment program, from firm transportation customers. The responsibility for those costs, will be decided in the context of Multiple Intervenors petition or in another forum.

LDCs will be provided a reasonable opportunity to recover strandable costs if they can demonstrate compliance with our directives to minimize such costs. Specifically, LDCs are expected to evaluate and aggressively pursue options to address strandable costs, to actively encourage competition including collaboration with marketers to expand the number of customers taking transportation service, and to provide customer education.[1/] The desirability of auctioning remaining capacity contracts should be revisited in the future, especially if FERC adopts recently proposed changes to its capacity release rules.

We will direct staff, LDCs, marketers and other interested stakeholders to address several issues associated with the termination of capacity assignment, including treatment of capacity on intermediate pipelines, where relevant, and recovery mechanisms for stranded costs.

SUMMARY OF STAFF ACTION ITEMS

1. Staff shall convene collaborative meetings to address issues related to:

    (a) system operation and reliability; and

    (b) the elimination of capacity assignment as discussed herein.

2. Staff shall initiate a process to address issues related to market power as discussed herein.

3. Staff shall report to the Commission as to the status of the following as of April 1, 1999:

    (a) the above collaborative efforts;

    (b) the outcome of its initial discussions with the LDCs, including proposed dates for initiating negotiations; and

    (c) the status of any negotiations under way at the time.

[1/] See Case 93-G-0932 Order Clarifying April 1998 Excess Capacity Filing Requirement, (issued September 4, 1997).

<u>The Commission orders</u>:

1. The mandatory assignment of capacity allowed by our March 28, 1996 order in Case 93-G-0932 is terminated. Each LDC shall file proposed tariffs, by no later than February 1, 1999, to conform to this requirement.

2. These proceedings are continued.

By the Commission,

(SIGNED) DEBRA RENNER
Acting Secretary

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 97-G-1380 - In the Matter of Issues Associated with the Future of the Natural Gas Industry and the Role of Local Gas Distribution Companies.

NOTICE OF DETERMINATION
OF NON-SIGNIFICANCE

NOTICE IS HEREBY GIVEN that an Environmental Impact Statement will not be prepared in connection with the adoption by the Public Service Commission of policies regarding competition in the natural gas industry. This decision is based on our determination, pursuant to Part 617 of the implementing regulations pertaining to Article 8 (State Environmental Quality Review Act) of the Environmental Conservation Law, that our policy will not have a significant adverse effect on the environment. The exercise of this approval is an unlisted action as defined in 6NYCRR Section 617.2(ai) and 617.4(b). Our policy, if effectuated, will affect all areas of New York State which are currently served by natural gas or are likely to be served in the future.

Large customers have had the option of purchasing gas from a non-LDC supplier (marketer) since the 1980s and all customers have had this option since 1996. While many larger customers purchase gas from marketers, competition has been slower to develop in the residential and commercial sectors. The Commission’s policy statement envisions the LDCs separating the distribution function from the competitive merchant function.

This policy, if effectuated, should result in a decline in the cost of gas for smaller customers which will, in turn, somewhat increase demand. Since most of this increased demand is likely to result from customers switching to gas from dirtier fuels, the net air quality impact of the increased sales will be neutral and possibly positive.

More aggressive marketing of gas might result in an increase in gas franchise expansions, with a potential for a variety of environmental impacts from distribution line construction, however, since the individual distribution projects are subject to SEQRA review at the time of Commission action, these speculative impacts need not be considered at this time.

The Commission anticipates that the LDCs will submit individualized plans to effectuate this policy. The LDCs shall submit draft environmental assessment forms with these individual proposals.

The address of the Public Service Commission, the lead agency for purposes of Environmental Quality review of this policy is 3 Empire State Plaza, Albany, New York 12223-1350. For further information, contact Martin Cummings at (518) 474-5365.

DEBRA RENNER
Acting Secretary