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By Federal Express

Hon. John C. Crary
Secretary
Public Service Commission
State of New York
Three Empire State Plaza
Albany, New York 12223

Re: ***Case 98-G-0122 - Proceeding on Motion of the Commission to Review the Bypass Policy Relating to the Pricing of Gas Transportation for Electric Generation***

Dear Secretary Crary:

In accordance with the Commission's March 25, 1998 "Notice of Service List" issued in the above-referenced case, enclosed please find an original and 10 copies of the "Initial Joint Comments of The Brooklyn Union Gas Company and Long Island Lighting Company."

Copies of the enclosure are being served this same day on all parties by regular mail.

Please acknowledge receipt by date stamping the enclosed copy of this letter and returning it in the self-addressed, stamped envelope provided herein.

Yours truly,

Richard A Visconti

Of counsel for
Long Island Lighting Company

Steven L. Zelkowitz

Of counsel for
The Brooklyn Union Gas Company

cc (w/encl.): All parties

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission to Review the Bypass Policy Relating to the Pricing of Gas Transportation for Electric Generation	:	Case 98-G-0122

INITIAL JOINT COMMENTS OF THE BROOKLYN UNION GAS COMPANY AND LONG ISLAND LIGHTING COMPANY

The Brooklyn Union Gas Company ("Brooklyn Union"), a natural gas local distribution company ("LDC") serving approximately 1.1 million customers in New York State, and Long Island Lighting Company ("LILCO") a combination natural gas LDC and electric utility serving over 460,000 gas customers and over 1 million electric customers in New York State, hereby submit the following comments in response to the Commission's "Order Instituting Proceeding and Technical Conference," issued and effective January 30, 1998" ("Order"), as supplemented by the information provided by Staff at the technical conference held February 26, 1998. The names and addresses for service of all correspondence and pleadings directed to Brooklyn Union and LILCO in this matter are:

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Introduction

The experience of Brooklyn Union and LILCO with individually negotiated contracts for transportation service, while involving only a limited number of contracts, has included both relatively large and smaller projects that presented issues of physical bypass, load retention, load attraction and combinations of physical and economic bypass. The experience of both companies operating under the Commission's current pricing policies for gas transportation for electric generation generally has been positive, in that both companies have been able to realize margin revenues derived from the rendition of service to such facilities that have been realized by core gas customers. The companies believe that the existing policies allow them to maximize net benefits for core gas customers and result in a fair and equitable allocation of the value of gas transportation as between the LDC and its electric generation customers.

The value-based principles that underlie the Commission orders related to physical and economic bypass[1] ("Bypass Policy") have allowed Brooklyn Union and LILCO to respond in a timely and effective manner to the competitive alternatives of this non-core market. In the future, as the number and complexity of competitive options increases for all customers, especially non-core customers, such principles will become increasingly more important price regulators in the energy market, and therefor represent the most effective way to strike an economically sound balance between an LDC's public service obligation to maximize the value of system assets for the benefit of its core customers, and concerns over unduly burdening the potential for unregulated generation to create the cost savings anticipated from restructuring the electric industry.[2]

Both Brooklyn Union and LILCO see the potential for profitable throughput growth for the benefit of themselves and their respective core gas customers in the market for transportation services for electric generation, by actively competing with physical and economic bypass alternatives available to new facilities on Long Island and existing facilities in Brooklyn Union's service territory. However, the ability of both Brooklyn Union and LILCO to realize such growth

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[1] *Re Bypass by Gas Cogeneration Projects*, Case 90-G-0379, 120 P.U.R.4th 385 (March 6, 1991); *Clarification of Statement of Policy Regarding Bypass*, Case 90-G-0379, 31 NYPSC 2057 (Aug. 12, 1991); and *Restructuring of the Emerging Competitive Gas Market*, Case 93-G-0932, Opin. No. 94-26, 158 P.U.R.4th 553 (Dec. 20, 1994).

[2] In addition, Brooklyn Union occupies a relatively unique position in the emerging New York energy market, since it is a gas-only utility that has in its service territory not only large electric generating facilities owned by independent power producers that are taking gas transportation service from Brooklyn Union, but also large utility-owned generating stations that the incumbent electric utility — Consolidated Edison Company of New York, Inc. ("Con Edison") -- currently serves with gas purchased by its electric division, and of which Con Edison plans to divest itself. *See* Con Edison's recently filed divestiture plan (*Consolidated Edison Co. of New York*, Case 96-E-0897, "Generation Divestiture Plan and Petition" at 39 (Feb. 27, 1998)), which indicates that Con Edison intends to sell its Arthur Kill generating station in Staten Island and its Gowanus turbine facility in Brooklyn.

opportunities will be highly dependent on Commission policies resulting from this proceeding that provide all LDCs with the appropriate tools to compete effectively against market alternatives, and do not result in an unnecessary subsidy of core electric consumers by core gas customers.

Before responding to the specific questions on which the Commission seeks comment, Brooklyn Union and LILCO offer the following observations regarding Downstate market conditions that should serve as the context for the Commission's review of whether and to what extent the traditional pricing principles of its Bypass Policy should be continued for the non-core, large scale electric generation market.

Market Conditions

1. Adequate Competitive Options Exist in the Downstate Region to Allow Market-Based Rates for Local Transportation Service

The Bypass Policy was established to provide LDCs with the ability to participate in the emerging, unregulated energy marketplace and prevent unnecessary physical and economic bypass of LDC transportation systems by non-utility generating projects. This policy is consistent with longstanding Commission value-of-service pricing policies for non-core markets that provide optimum benefits for core gas customers through the addition of (or the retention of) existing contributions to fixed costs from the use of LDC facilities to serve those markets. In many portions of the State, LDCs find themselves in a fairly complex competitive market. Despite the fact that each LDC is a monopoly service provider in its respective service territory, existing natural gas and electric transmission "grids" provide generation developers the siting flexibility needed to place neighboring LDCs in competition to provide transportation services. In addition, existing generation units have competitive fuel options that they can and do exploit when alternate fuel prices fall below the burner-tip price of gas. Indeed, the contested market may extend beyond project load and include the secondary business tier where a generation facility may be able to displace the thermal loads of existing gas utility customers through the sale of project steam and/or electricity.

The Downstate region is a particularly good example of such a competitively complex market. There are five in-state[3] and six LDCs in neighboring states,[4] all in relatively close proximity, that have the potential to offer transportation and other related services to existing and new generation projects. Participants in the generation market will, of course, have the ability to design new generation facilities in a manner that will take full advantage of competitive gas transportation and related services alternatives among LDCs, alternative fuel suppliers, as well as the specialized product providers entering the energy market (*i.e.*, those offering balancing, peaking and other supply management services).

2. Market Based Pricing Authorized under the Commission's Current Policy Is the Proper Methodology for Setting Transportation Rates in the Region

Unless there is evidence that market alternatives are unavailable in some segment of an LDC's system, there is no economically justifiable reason to abandon the current market-based pricing policy for the electric generating segment of the non-core market. Resort to a regulated pricing structure based on either fully allocated or marginal cost-of-service principles is entirely unnecessary in the Downstate region, where there is a market with existing and expanding

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[3] Brooklyn Union, LILCO, Con Edison, Orange and Rockland Utilities, Inc. and Central Hudson Gas & Electric Corp.

[4] Public Service Electric and Gas Co., Elizabethtown Gas Co. and New Jersey Natural Gas Co., in New Jersey; The Southern Connecticut Gas Co., Connecticut Natural Gas Corp. and Yankee Gas Services Co. in Connecticut.

competitive alternatives. Furthermore, resort to strict cost-of-service pricing (either fully allocated or marginal) is likely to result in rates that are either (i) too low, generating subsidies from core gas customers to the equity owners of electric generation facilities, or (ii) too high, eliminating opportunities for LDCs to capture the real value of their service in the non-core energy market. In either case, rate for core gas customers would be higher than they would be under a continuation of the current Bypass Policy pricing.

3. Standardized Local Gas Transportation Charges Will Not Provide Economically Sound Output Pricing in the Electric Retail Market

In the Order (at 8), the Commission expresses concern that current value-of-service pricing may not properly allocate between gas and electric customers the economies expected from restructuring. Although there may be some theoretical linkage between gas transportation rates and the ultimate price electric customers pay for service, it is important to note that natural gas transportation rates are only one component in the mix of fixed and variable cost elements that go into developing project output pricing. Indeed, owners of electric generation facilities face competing options for financing, siting, environmental management, construction, operating and management services, and matching target markets with generating technologies, in addition to fuel commodity supplies and transportation services. There is no "correct" balance among these components — certainly not one that can be administratively determined — and the mix of cost elements differs from one facility to the next. The current Bypass Policy allows the establishment of the proper pricing level for local transportation service among project cost components using the law of the free market, which applies to all market participants, rather than the law of regulation, which skews the result by its application to only a portion of the market. If the Commission were to impose standardization in LDC transportation rates among all new and existing large scale generation facilities, it would not "level" the playing field as between gas and electric consumers. Rather, it would only cause a rebalancing of value among the remaining parties comprising the project cost components in a manner that could not be predicted or controlled by regulation.

QUESTIONS TO BE ADDRESSED

A. ***Policy***

1. How should the existing policy be modified/clarified for application to gas transportation for electric generators?

The Bypass Policy allows for negotiated contracts as between gas service suppliers and gas users with alternatives to gas use. The Bypass Policy requires similarly situated customers to be comparably priced, but contract terms can be differentiated based on costs, value or other considerations. Thus, the Bypass Policy creates conditions that place LDCs on the same footing as their fuel oil and other competitors who have no restrictions on negotiating contracts with electric generators or other energy users.

Hence, the Bypass Policy will be most effective in guiding LDC responses to opportunities presented by non-core electric generation if its principles are clearly understood by all participants. Therefore, Brooklyn Union and LILCO recommend that the current pricing policy both be reaffirmed and its principles clarified as follows:

- Standard tariff provisions seldom will be flexible enough to allow an LDC to capture the market value of local transportation service to large scale electric generation customers. Therefore, although standard tariffs should continue to be available to all gas customers, the alternative of individually negotiated contracts are the more appropriate vehicle to establish rates and service terms for the needs of a market comprised of customers each of which have very unique expectations from and impact on an LDC's system.

- Such contracts must provide net benefits that reflect the full market value for the service(s) provided, based on both monetary and non-monetary considerations. At a minimum, such benefits must recover at least the incremental cost of service over the life of the contract, as determined at the time the contract is entered into, and some contribution to the recovery of system fixed costs. In assessing whether the contract provides net benefits, the LDC must determine that the overall system wide benefits that would obtain under the contract exceed those that would obtain if no individually negotiated contract were consummated.

- Expected revenues from existing LDC customers displaced by energy services from an electric generator, both at the time of contract and those reasonably expected to be displaced during the course of the contract, should be fully recovered in rates charge the generation facility, unless there is evidence that further discounting is needed to meet the competitive alternatives available to the potential generation customer. However, such discounting should not result in rates that fail to recover the full incremental costs of service to the customer.

- No cap on specially negotiated contract rates is required, so long as non-core customers have recourse to standard tariff service.

- Each LDC should have the responsibility to evaluate requests for specially negotiated contracts on a case-by-case basis, subject to the principles for distinguishing among customers recognized under the Public Service Law, Commission policies and the relevant anti-trust principles.

- Each LDC must be prepared to submit reasonable evidence of compliance with the Bypass Policy for each specially negotiated contract.

With the principles and processes for developing and implementing specially negotiated rates and service terms clearly defined and market based, Brooklyn Union and LILCO are confident that contract negotiations will continue to be conducted and concluded efficiently.

2. ***Is value of service pricing appropriate?***

Yes, as discussed above, value of service (*i.e.*, market-based) pricing for non-core markets is appropriate whenever there is a "workably competitive market" to function as a price regulator in determining service terms and rates. Indeed, to modify the Bypass Policy by requiring strict cost (either fully allocated or marginal)-of-servicepricing would be inconsistent both with the economic principles which form the foundation of restructuring in both the gas and electric industries, as well as with established economic theory. It is well established that price regulation is designed to produce results that otherwise would be produced by the free market. When, as is the case with non-core customers, especially large scale generation facilities, there are market alternatives available, cost-of-service price regulation is both unnecessary and unlikely to produce an economically efficient result.

3. ***Should the same policy apply to all electric generators?***

- ***existing vs. new generating plants***
- ***upstate vs. downstate***
- ***LDC affiliate vs. non-affiliate***
- ***size of generator***
- ***other criteria***

The Bypass Policy should continue to apply to existing and new generating facilities. Generators typically have sought long-term transportation contracts because of their need for certainty in order to secure long term project financing. If the Commission should modify the Bypass Policy, it should not upset any *existing* contractual arrangements between LDCs and generators or other customers.

Size and other individual characteristics of the customer's situation should continue to be the basis under the Bypass Policy to set economically appropriate rates and market responsive service terms for existing and new participants in the restructured electric generation market. Exceptions may need to be established to deal with the infrequent instances where customers lack competitive options to the use of a particular LDC's facilities, or alternative pricing is justified as a transitional measure.[5]

Given the complexity of and diversity among the mix of cost components for each generation facility, market-based pricing of all components, including local gas transportation service, is the most reliable and objective way to allocate value. This applies not only to allocation among service suppliers to a project, but also between suppliers and the second tier markets such as retail sales of steam and electricity.

Of course, this approach will result in different rate levels among otherwise superficially "similar" electric generation plants. However, pricing distinctions based on competitively priced alternatives (a) are direct reflections of market forces in the energy industry, (b) allow value to be derived based on the net benefits available from the particular characteristics of each project in its unique market niche, and (c) are consistent with pricing equity concepts under the anti-trust laws. These contracts can be expected to be different among individual electric

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[5] For example, as discussed below, if, in the Commission's case-by-case review of the propriety of making the transfer price charged by a the gas division of a combination company to its electric division portable for any generation facilities divested by the combination company, the Commission determines that the existing transfer price is either too high or too low when measured against the price that would obtain through an application of the Bypass Policy, the Commission may wish to employ an alternative pricing scheme during some transition period to avoid any "rate shock" to either core gas customers (if the transfer price is too high) or core electric customers (if the transfer price is too low) that might occur if the Bypass Policy pricing principles were employed immediately after divestiture.

generation facilities due to such facts and value for the service, including providing rights to peaking supplies to the LDC's core gas customers in the heating season and location in the LDC's service territory. Location will affect a generation facility's costs in two ways. First, it makes bypassing the LDC's system more or less feasible in comparison with other locations. Second, it determines the frequency of potential interruptions of transportation service. Generation facilities located in restricted sections of the LDC's distribution system will experience interruptions that other generators and potentially incur higher production costs.[6]

Concerns over the application of the Bypass Policy by an LDC to affiliated companies are readily resolved under the affiliate transactions guidelines established by the Commission to deal with actual or perceived market power issues in other portions of the restructured energy market.[7] Hence, any LDC affiliates that sell electricity into a competitive market should be provided gas transportation service in a non-discriminatory manner consistent with the Bypass Policy, and be accorded no preferential treatment. In this way, the Commission can ensure that LDCs do not provide an anti-competitive advantage to their generation affiliates that sell into the competitive market and that benefits core gas customers receive from the regulated gas transportation system are maximized.

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[6] Of course, these higher production costs may be more than recoverable in output prices, especially if the particular location chosen is a localized load pocket.

[7] For example, LILCO and Brooklyn Union are subject to standards of conduct and affiliate pricing rules contained in the Settlement Agreement recently approved by the Commission in Case 97-M-0567(*Long Island Lighting Company and Brooklyn Union Gas Co.*, Case 97-M-0567, "Order Adopting Terms of Settlement Subject to Changes and Conditions" (Feb. 5, 1998)) and several other LDC's are subject to similar standards negotiated in restructuring proceedings. *See, e.g., Consolidated Edison Co. of New York*, Case 96-E-0897, "Opinion and Order Adopting Terms of Settlement Subject to Conditions and Understandings" (Nov. 3, 1997).

4. ***With respect to LDC services for generation, what are the impacts on core electric and core gas customers? How should they be balanced? How does Public Service Law §66-d limit the options (e.g., what is an "undue burden").***

The Commission is faced with the challenge of promoting deregulation in the electric retail market, while fulfilling its statutory obligation to ensure that *both* electric and gas customers receive safe and adequate service at just and reasonable rates. Public Service Law ("PSL") §§ 5, 65. However, any benefits that are intended by the Commission to be realized by core electric customers as the result of any pricing policy for gas transportation adopted in proceeding should not and cannot be achieved at the expense of or create an "undue burden" on core gas customers. *See* PSL. §66-d. The margin revenues that inure to the benefit of core gas customers of both Brooklyn Union and LILCO today from the application of the Bypass Policy and non-core tariffed service is a significant factor in minimizing rates to these customers, and the potential opportunity for additional margins from growth in non-core markets, especially the electric generation market, resulting from a continuation of the Bypass Policy, will provide still greater benefits in the future.

In its re-examination of the Bypass Policy as applied to gas transportation rates for electric generation, the Commission should be mindful of section 66-d, which authorizes the Commission, under certain conditions, to require and set just and reasonable terms for transportation of producer or customer-owned gas by an LDC. Under section 66-d, transportation may be required only if the Commission concludes, among other things, that no "undue burden" is placed upon an LDC's customers.[8]

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[8] In addition to this requirement, section 66-d(2) establishes two other criteria that must be satisfied before the Commission can order a public utility to transport natural gas: (1) the (continued...)

There are many factors that should be considered in determining the meaning of "undue burden" in the present context. For one, as discussed more fully below, the Commission should factor in lost revenues from gas load displaced by sales from the electric generator to existing LDC customers in the development of gas transportation rates for electric generation facilities. This is entirely consistent with previous Commission decisions in which an undue burden was found in circumstances where service to one customer would result in a loss of revenue margins received by the utility from other customers.[9]

Other guidance for a determination of whether the rates, terms and conditions of gas transportation service can be ordered under PSL § 66-d without undue burden on the LDC and its existing customers and are otherwise "just and reasonable" is provided by reference to section 65 of the PSL.[10] Section 65 supports the view advocated in these comments that value-of-service pricing is the appropriate methodology and that there is no need to standardize prices for local gas transportation rates for electric generation. The analyses in these comments and the Commission's consistent experience provide abundant support for the proposition that LDCs should continue to

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[8](...continued)
utility must have available capacity; and (2) the transportation will not affect the ability of the utility to render adequate service.

[9] *See People Ex Rel N.Y. Edison Co. v. Pub. Serv. Comm'n*, 191 App. Div. 237, 241 (1st Dep't), *aff'd* 230 N.Y. 574 (1920) (Commission lacks jurisdiction to require public service corporation to provide service to competitor to entice away its customers); *see also*, *Sithe/Independence Power Partners, L.P.*, Case 94-E-0136 "Order Supplementing Certificate and Establishing Equalization Fee" (Nov. 3, 1994) (Competitor of electric utility directed to mitigate the impact on core customers of lost margin revenue).

[10] All parts of a statute must be harmonized with each other as well as with the general intent of the whole statute, and effect and meaning must, if possible be given to the entire statute and every part and every word thereof. Statutes § 98 (McKinney 1971).

apply specific market criteria to distinguish among customers when pricing gas transportation for electric generation. Section 65 provides the legal bases for these distinctions.

Specifically, section 65 specifies certain criteria upon which an LDC may distinguish among customers and services, such as quantity, term, end-use, timing and duration of use, type of service and any other reasonable consideration.[11] Other factors that historically have been used by LDCs and the Commission to develop individual customer rates and terms include but are not limited to: the location of a customer on the utility's system; the fuel and other competitive alternatives available to or confronted by a customer; the degree (if any) of contemplated service interruptions; and the customer's load factor and usage characteristics. In adopting the Bypass Policy,[12] the Commission authorized LDCs to distinguish among customers based upon differences such as incremental costs to serve, higher pressure service requirements, longer-term arrangements, dual-fuel capability, increased utilization of system capacity, impact on gas supply management, system gas costs, dispatch/balancing implications, and future capacity expansion considerations attributable to serving larger volume customers.[13]

These legal considerations further support the market reasons for retaining the existing Bypass Policy, which provides a well-focused guide to transactions in the current and future

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[11] While PSL §65 requires a gas corporation to employ like terms and rates "for doing a like and contemporaneous service . . . under the same or similar circumstances or conditions" and not "grant any undue or unreasonable prejudice or disadvantage in any respect whatsoever," it permits a gas corporation to employ "classifications of service based upon" these factors.

[12] *Re Bypass by Gas Cogeneration Projects*, Case 90-G-0379, 120 P.U.R.4th 385 (March 6, 1991).

[13] *Id.* at 393-94.

energy markets.[14]

5. ***Should existing transfer prices for LDC services to the electric department of combination utilities be portable when plants are auctioned, e.g. should they go to the new owner of the generator?***

The transfer accounting conventions adopted by combination gas and electric utilities for gas transportation service in support of their own electric generation appear to reflect case-by-case determinations in which the Commission attempted to reflect a proper allocation of value to gas and electric consumers of a single utility. For example, with respect to the transfer price for gas used in electric boilers, LILCO has applied the same approach of maximizing the benefits to its core gas customers that is embodied in the Bypass Policy. LILCO's Gas Department has sought to maximize these benefits in the imputed price allocated to and negotiated with its Electric Department, and these imputed prices have been reviewed and approved by the Commission. Thus, the prices "charged" by LILCO's Gas Department to its Electric Department are comparable with the rates charged other generators on Long Island as the result of individually negotiated agreements, after accounting for differences in individual characteristics and circumstances. Accordingly, where existing transfer prices are, and were determined to be, consistent with the Bypass Policy, there is no reason why they should not be portable. However, to the extent that the transfer prices of combination companies are

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[14] As the Commission concluded in the Gas Restructuring Proceeding, with respect to non-core customers, PSL §65 permits gas companies to (i) "have a great deal of discretion to set the prices of their own services to non-core customers . . . that they are comparable to the prices of alternatives available to those customers;" (ii) "recognize competitive conditions that distinguish otherwise similarly situated customers, as a basis for charging them different rates;" and (iii) continue to seek to maximize revenues by utilizing "value of servicing pricing [because it] . . . is responsive to changes in energy prices generally and [gas companies] will continue to need additional flexibility in responding to competitive pressures." *Restructuring of The Emerging Competitive Gas Market*, Opin. No. 94-26 *mimeo* at 31, 158 P.U.R.4th 553 (December 20, 1994).

inconsistent with the results that would be produced by an application of the Bypass Policy, these prices need to be reviewed and revised on a case-by-case basis.

Moreover, as discussed above, there are Con Edison facilities located in Brooklyn Union's service territory that are included among the assets selected for transfer under the Con Edison Generation Divestiture Plan. At present, through the operating arrangement for Con Edison, Brooklyn Union and LILCO for the New York Facilities System,[15] Con Edison is able to provide gas to these plants and use Con Edison transfer price accounting for such transactions. Whatever transitional rules the Commission may wish to adopt for transfer price accounting between the gas divisions of combination companies and the new owners of generation facilities divested by those companies, cannot apply to the provision of gas transportation services by Brooklyn Union to the soon-to-be former Con Edison facilities located in Brooklyn Union's service territory. Rather, the prices for those transportation services should be developed through the employment of the policy guidelines for pricing of transportation service for electric generation adopted by the Commission in this proceeding.

6. What criteria should be considered in determining whether customers are "similarly situated"?

Based on the load retention cases in the industry,[16] it is apparent that the detailed

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[15] The New York Facilities System is a network of high pressure gas transportation facilities located in the service territories of the three utilities, which are interconnected to interstate pipeline facilities. The Facilities System pipelines are owned severally by each of the three utilities in their individual service territories, but are operated cooperatively for the mutual benefit of the three companies.

[16] *See, e.g., Brooklyn Union Gas Co.*, Case 92-G-0847, Opin. No. 93-10 (June 16, 1993) and *Consolidated Edison Co. of New York*, Case 93-G-0632, Letter Order (Nov. 18, 1993).

competitive market analysis required under the Bypass Policy has advantages over formalized attempts to define "similarly situated," or "like and contemporaneous service," since it relies upon the economic facts of the relevant markets to distinguish one customer from another, such as:

- The market value of services in light of bypass alternatives, both physical and economic, in all relevant markets

- Incremental costs related to a facility's impact on the LDC's distribution system

- Operational benefits/burdens of a particular project (*i.e.*, economies of scale in plant design and location, flexibility in delivery locations on the LDC's system, level of deliverability required, level of balancing or other back-up service required, load factor, availability and reliability of gas peaking services, ability to displace existing LDC load through direct sales to LDC customers, etc.)

- Creditworthiness, including ability to finance incremental costs rather than requiring the LDC to recover its investment in project rates.

7. ***Should lost revenues from gas load displaced by energy from the electric generator be factored into the development of the gas transportation rate for the generator? If so, how?***

For rates that are individually negotiated, lost revenues from gas load displaced by energy from the electric generator should always be a factor in assessing the net benefits available from specially negotiated gas transportation rates. Neither core gas customers nor the LDC should be *worse off* for having entered into such transactions. Such a transaction clearly would fail the "net benefits test" employed by Brooklyn Union, LILCO and other LDCs in assessing whether to provide service under individually negotiated rates. It makes no economic sense to require LDCs to offer non-standard transportation rates to a generation facility to the point that the facility can achieve an artificially low enough price in the secondary market which can displace the LDCs existing customers, and result in a net loss to the LDC and its core gas customers.[17] However, as discussed earlier, where the generation facility has a physical or economic bypass alternative that can be shown to be priced at a point that will reduce or eliminate the existing LDC load, margin levels, down to the incremental costs to serve the generation customer, must be available for sufficient additional discounting to respond to the competitive threat.

B. Tariff vs. Negotiation

1. Are individually negotiated contracts between LDCs and generators compatible with the development of a competitive, non-utility, electric generation industry?

Yes, such customer specific, market sensitive options are the only effective way of allowing LDCs to obtain full economic value from system assets devoted to serve core customers. Costs of production are hardly ever the same for two firms in any industry and certainly not for two generation facilities in the electric industry. Generators have different capital costs, construction costs, operating efficiencies (heat rates), maintenance costs, etc., so there is no logical reason that fuel costs should be the same. Competitive firms use these differences to increase market share and profitability. Therefore, negotiated contracts, with different price levels and supply conditions, are consistent with a competitive electric generation industry. The Bypass Policy both encourages and

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[17] In this regard, in addition to their basic public service obligations, all LDCs have an economic incentive to minimize core service rates to improve their competitive position in core markets against alternate fuels, such as fuel oil for space heating in residential and small commercial markets. Hence, LDCs have the incentive to maximize total margin revenues to minimize unit core service rates. Moreover, since Brooklyn Union is at risk for all systemwide margin revenues (both core and non-core) for the length of its rate plan, which extends through September 30, 2002, it has an additional incentive to price transportation services to new and existing non-core customers in a manner that will maximize *total* system margin revenues, whether derived from the generation facility itself or derived from other customers, including those whose thermal load may be served by such facility.

requires LDCs to pursue this goal. Any changes in the Bypass Policy, to the extent they restrict the ability of LDCs to price non-core services in this manner, will tend to benefit equity owners of generation facilities, fuel oil suppliers, or LDCs and their customers in neighboring states at the expense of New York State's gas consumers.

2. *Should the utility still be expected to maximize revenues from a negotiated contract or should the rates be developed based solely on average or marginal costs?*

LDCs should be expected to and will act in the same manner as any other competitor in a workably competitive market. They should be permitted to and will price their services in a manner that is designed to recover pure variable costs and maximize total margin contributions to fixed cost recovery, reflecting also the value of non-monetary benefits such as flexible interruption rights, and access to reliable customer-owned supply to serve LDC customers on colder winter days.

In this regard, it is important that the Commission not misapply the economic concept of marginal cost pricing. Although, in economic theory, prices set at marginal costs maximize the allocation of resources, a competitive market (and the efficiencies it achieves) is driven by the motive to realize margin revenues in excess of marginal costs. To achieve such margin revenues, suppliers seek to reduce their costs and provide a product whose value to consumers exceeds the suppliers' marginal costs. To merely impose a price based on marginal cost is less desirable than allowing the price to be set by the market because the pre-set "marginal cost-based price" (a) may in fact not reflect the true marginal cost, and (b) would result in the LDC foregoing any of the margin between cost and a market clearing price that customers would be willing to pay in a competitive market. Seeking to maximize the margin revenues from a negotiated contract with a non-core customer, including an electric generation facility, rather than setting the price at marginal costs (i) provides an more efficient mechanism to drive the cost of energy towards marginal cost, and (ii) enables the LDC to maximize the benefits for core gas customers while satisfying the needs of non-core customers at market clearing prices.

3. Should standard tariffs be developed for electric generators? Is it feasible to unitize prices for LDC services for electric generation such as:

- ***location on the distribution system***
- ***maximum daily quantity***
- ***minimum daily quantity***
- ***interruption criteria***
- ***term of rate***
- ***balancing provisions***
- ***peaking services***

Standard tariffs are appropriate to establish eligibility requirements and define the methods used to develop individually negotiated rates and terms; and are appropriate as well where the customer is small and it makes no sense to enter into an individually negotiated transaction. However, the inherent differences in requirements of and benefits from large scale generation projects do not economically justify standardized pricing. As discussed above, costs of production are hardly ever the same for any two generation facilities. All cost inputs for these facilities vary and there is no logical reason that fuel costs should be the same. Accordingly, given the size of these facilities and their available alternatives, negotiated contracts, with different price levels and supply conditions, are entirely consistent with and necessary for the development of a competitive electric generation industry.

For example, one of the most competitively sensitive issues may well be how much, if any, of the incremental costs for interconnection will be recovered in rates. Although setting this level through regulation might provide some leveling of the playing field, it is not a market factor that is related to the value of transportation service. So long as the core LDC customers are not put at risk for such costs, each facility should be allowed to balance its own cost elements.

A similar dysfunctional result would result from establishing a fixed unitized rate as an absolute standard for all electric generators without regard to the total net benefits from or competitive options available to one generator as compared with another. Under such a scheme, a generator whose annual maximum throughput is 20 BCF would yield 10 times the annual net revenue of an electric generator whose annual maximum throughput is 2 BCF. At issue here is not what the appropriate *unit rate* should be, but instead a recognition of the *total value* achievable in a competitive market.

For the same reasons, it would be equally unwise to prescribe fixed unitized rates for other unbundled services, such as balancing, back-up, and other supply management services. The value of such services in the non-core market can now be determined with reference to a growing number of competitors entering the energy market with such services, and LDCs should be permitted to price such services in a manner that would reflect such competitive options.

4. Should or can a system using both tariffs and negotiations be pursued?

Yes, the principles enunciated in Order 94-26[18] will continue to apply regarding the use of cost-based rates for any portion of the market that is without competitive alternatives, as recourse rates against which to compare value-based pricing offered by an LDC, and as an alternative for customers who may have market options but do not desire to participate in the risks attendant to the transition process.

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18 *Restructuring of the Emerging Competitive Gas Market*, Case 93-G-0932, *supra.*

5. *Is the provision of tariffed rates necessary to insure open access?*

No. The Commission's current polices and section 66-d of the PSL provide for an open access regime pursuant to which all participants may receive transportation service so long as the section 66-d standards are satisfied (available capacity, no undue burden, no impairment in ability to render adequate service). Non-core customers, as defined by the Commission, have alternatives.[19] One of those alternatives is to take service at standard tariff rates. Thus, under the Commission's current regime, all customers are assured access to the LDC's transportation system (assuming the 66-d standards are satisfied) and the issue for large scale electric generators is not whether they have access to transportation service, but the price and other terms and conditions of that service.

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19 *Id.*

C. *Pricing/Technical*

1. ***Should Rate Schedules specifically provide for:***

- ***Various degrees of interruptibility and priced accordingly?***
- ***Gas peaking services that are made available from a generation facility and priced accordingly?***
- ***Various levels of balancing services to electric generation priced accordingly?***
- ***Terms for siting on an LDC's system; can pricing conditions for locational differentials be predetermined?***
- ***Any other services?***

As discussed previously, these types of service distinctions have different value to different generation facilities. To attempt to create a standard, tariff-based price and price differentials based on location, degree of interruptibility, etc., not only would be virtually impossible, but also would diminish the competitive value each project obtains from its unique operating and locational characteristics, and would assure only that the value received by core gas customers from the non-core customers is not correctly matched with actual market value, resulting in inefficient pricing. These distinctions are best dealt with through individually negotiated contracts.

2. ***Should a utility have to accept an offer of gas supply peaking service? Under what terms?***

No. LDC supply portfolios reflect a diverse mix of supply sources designed to assure reliable service under design weather conditions. Peaking service is a component of such a portfolio, and the LDC should evaluate any offer of peaking service from an electric generation facility based on the same factors used to evaluate supply services generally. To *require* an LDC to accept an offer of peaking services from an electric generating facility likely would result in the LDC acquiring a supply it does not need, or acquiring it at a price that exceeds the LDC's market alternatives.

3. ***How should gas peaking services be handled/reallocatedif the LDC exits the merchant business?***

A market for such services is developing for on-system and off-system customers. This competitive market should be relied upon to value the temporary or permanent transfer of these assets to third parties. These gas supply assets should be considered as part of an overall plan of portfolio management both while LDCs retain their full merchant function, during any transition period, and after they have ceased to perform that function, if that occurs.

Moreover, the issues presented in this question are related directly to the broader issues that are being addressed in Case 97-G-1380.[20] They include maintaining upstream assets and/or on-system peaking supplies to provide balancing services and related supplier of last resort and reliability of service issues as they relate to sales customers converting to transportation. These issues have not been quantified of defined by the Commission, and the extent to which LDCs will cease providing merchant service, and the timing of any such cessation, are wholly uncertain at this

[20] *In the Matter of Issues Associated with the Future of the Natural Gas Industry and the Role of Local Gas Distribution Companies*, Case 97-G-1380.

point.

4. How should gas balancing services be provided if the LDC is no longer a merchant?

Balancing services may be provided on a competitive basis by LDCs and non-LDCs alike. It is expected that if LDCs cease providing merchant service they will need to retain some upstream capacity and on-system peaking services to enable them to provide the same flexibility provided to sales customers, including handling daily and hourly swings in delivery versus consumption. In connection with providing this flexibility, a system designed to provide disincentives for third party providers of gas to underdeliver daily nominations is essential to ensure that the assets required to provide this flexibility are kept at a minimum and that the LDC is reimbursed for the costs it incurs to provide balancing services from those participants causing the system to be out of balance. Clearly, the extent to which they should either be required or permitted to provide additional balancing services should be the subject in the overall consideration of whether and if so under what conditions LDCs should continue to perform merchant services.

CONCLUSION

For the forgoing reasons, Brooklyn Union and LILCO urge the Commission to continue in place policies that permit the State's LDCs to compete efficiently and aggressively in providing gas transportation services for electric generation facilities, and avoid the adoption of policies that may have the tendency to result in an unfair and inequitable subsidization of electric generation equity holders by core gas consumers and have a distortive effect on output pricing in the developing competitive electric generation market.

Respectfully submitted,

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