STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

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

REPORT AND RECOMMENDATIONS OF THE DEPARTMENT OF PUBLIC SERVICE STAFF

August 11, 1998

BACKGROUND

Large volume natural gas customers in New York State have been able to choose a gas supplier other than their local distribution company (LDC) since the mid-1980's. Today about 2800 large commercial, industrial and independent power generation customers use a non-LDC supplier/aggregator.

In December 1994, the Commission established a framework for restructuring the services provided by local gas distribution companies (LDCs)[1]. As a result, LDCs implemented small customer aggregation programs extending the right to choose a gas supplier to all customers.[2]. As of June, 1998 about 35,800 small customers have migrated to non-LDC supplier[3].

In approving LDC aggregation programs in March 1996, the Commission allowed LDCs to assign upstream capacity to aggregation customers for three years. After two years, each LDC would have to demonstrate efforts taken to reduce "excess" capacity.

On September 4, 1997 the Commission issued a notice inviting comments on a staff Position Paper concerning the future of the gas industry and the role of local gas distribution companies (LDCs). That report resulted from a staff initiated study which explored existing and emerging gas industry issues. Staff's report recommended actions, consistent with evolving industry trends, intended to expand competitive forces and increase customer choice.

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1 Opinion and Order 94-26 Establishing Regulatory Policies and Guidelines for Natural Gas Distributors, issued December 20, 1994, Case 93-G-0932.

2 "Order Concerning Compliance Filings", issued March 28,1996, Case 93-G-0932.

3 See Attachment 1 for a breakdown of these customers by LDC.

Comments and reply comments were requested by November 20 and December 20, 1997, respectively. The following 35 parties submitted comments and/or reply comments:

LDCs	Abbreviations
The New York Gas Group	NYGAS
The Brooklyn Union Gas Co.	Brooklyn Union
Consolidated Edison Co. of New York Inc.	Con Edison
Corning Natural Gas Corp.	Corning
Long Island Lighting Co.	Lilco
National Fuel Gas Distribution Corp.	NFDG
New York State Electric & Gas Corp.	NYSE&G
Niagara Mohawk Power Corp.	NMPC
Orange and Rockland Utilities, Inc.	O&R
Rochester Gas and Electric Corp.	RG&E
St. Lawrence Gas Co.	St. Lawrence

Gas Suppliers

Amoco Energy Trading Co.	Amoco
CNG Energy Services Corp.	CNG ES
Duke Energy Trading and Marketing, LCC	Duke
The Eastern Group	Eastern
Enron Capital & Trade Resources Corp.	Enron
Enserch Energy Services	Enserch
Market Access Coalition[1]	MAC
MC2 (a unit of MIDCON Corp.)[2]	MC2
North Atlantic Utilities, Inc.	NAU
Pacific Gas & Electric Energy Services	PG&E
Wheeled Electric Power Co.	WEPCO

Pipeline Companies

Columbia Gas Transmission Corp.	Columbia
CNG Transmission Corp.	CNG Trans
Empire State Pipeline	Empire
Iroquois Gas Transmission System	IGTS
El Paso Energy/ Tennessee Gas Pipeline Co.	TGPL
Texas Eastern Transmission Corp. and Algonquin Gas Transmission Co.	TETCO/AGT
Transcontinental Gas Pipe Line Corp.	TRANSCO

1 MAC includes AllEnergy Marketing, Horizon Energy Co., Keyspan Energy Services, Inc., NUI Energy, Pace Energy LLC and UGI Energy Services, Inc.

2 While MC2 provided useful comments, the company has since been dissolved.

Consumer Group Representatives

Public Utility Law Project of NY, Inc.	PULP
Multiple Intervenors	MI
Five individual NYSE&G gas consumers	

New York State Agencies

Consumer Protection Board	CPB
Department of Economic Development	DED

Other

Natural Resources Defense Council	NRDC
Preservation Coalition of Erie County	PCEC

Also on September 4, 1997 the Commission clarified actions that LDCs are expected to take to plan for competition and mitigate strandable costs[1]. The LDCS were directed to address these actions in their filings on "Excess Capacity" due April 1, 1998.

STAFF'S POSITION PAPER

Staff initiated a study to assess the future of the gas industry and the role of LDCs early in 1996. A discussion paper identifying existing and emerging issues affecting the future of LDCs was distributed to approximately 60 stakeholders representing producer, marketer, pipeline, LDC, consultant, customer and regulator interests. A series of 15 roundtable meetings were held with groups of these stakeholders to solicit views on those issues. Based on this input, staff prepared a Position Paper which contained the following fundamental conclusion and recommendations:

Fundamental Conclusion

The most effective way to establish a robustly competitive market in gas supply is to separate the merchant and distribution functions over a five year transition period.

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

Recommendations

(1) Eliminate impediments to LDCs exiting the merchant function:

 (a) LDCs should eliminate or restructure capacity contracts extending beyond 5 years[1], preferably by sale at auction.

 (b) The Supplier of Last Resort and Obligation to Serve functions to be provided by any and all gas suppliers.

 (c) System reliability should be assured primarily through reliance on market forces.

(2) Review rate design issues to identify changes required for a competitive market.

(3) Develop safeguards and monitoring mechanisms for market power issues.

(4) Enhance customer education programs.

(5) Refocus and streamline regulation as the industry evolves.

(6) Develop a mechanism for funding social programs.

(7) Help shape federal policies to assure a reliable and competitive upstream market.

SUMMARY OF COMMENTS, ANALYSIS, PROPOSED ACTION

The elements of staff's proposal -- the fundamental conclusion and recommendations contained in staff's report -- are addressed separately below. Each is restated, followed by a summary of the comments received, an analysis of those comments and staff's revised recommendation.

While these elements are addressed separately, they were presented as a package and it is important to insure that together they form a cohesive approach. For that reason, and

[1] Except for those contracts required to meet supplier of last resort obligations or system operational needs.

given the length of this section, staff’s revised recommendations are reviewed in their entirety in the CONCLUSIONS AND RECOMMENDATIONS section and reformulated as a vision, goals and implementation plan in the VISION and IMPLEMENTATION PLAN sections.

Staff has endeavored to fairly reflect the comments of the parties. For some issues the party’s arguments have been grouped and generally described without specific attribution, while for others there might appear a citation from one party’s comments that captures the view of several parties.

Finally, staff acknowledges that, based on continuing discussions, we are aware that some LDCs have modified their views on these issues since submitting comments. Specifically, two of the stronger supporters of LDCs exiting the merchant business, Brooklyn Union and National Fuel Gas have modified their stance; while they still support exiting the merchant business they believe that as a practical matter it may take considerable time and may be difficult if not impossible to achieve for small usage customer classes. Since these modified views were not submitted in writing they are not reflected in the following summaries but have been considered in the formulation of staff’s revised recommendations.

Staff’s Fundamental Conclusion

The most effective way to establish a robustly competitive market in gas supply is to separate the merchant and distribution functions over a five year transition period.

Summary of Comments

Nearly half of the commentators, including ten marketers, five LDCs, the CPB and MI, support staff’s fundamental conclusion.

NFG strongly endorses staff’s conclusion and states "At this junction, the question should be not "whether", but "how" LDCs should exit the merchant function". Brooklyn Union, through its strategic planning process has "adopted this strategic direction". Lilco "supports a workable transition that would separate the merchant and distribution functions". Enron states "... the continued existence of the traditional bundled LDC merchant function, in Enron’s view, has blocked economic access and discouraged the development of customer choice in the small commercial and residential markets. Accordingly, Enron supports the staff in its recognition that the only way to provide true consumer choice is to eliminate the LDC merchant function." PG&E states "it is entirely appropriate and timely for the staff and the Commission to address barriers to LDCs exiting the merchant function ..." The CPB states "... staff’s conclusion was generally accepted by most parties, including CPB, albeit with reservations regarding the provision of critical consumer protections afforded under the Home Energy Fair Practices Act (HEFPA)." NMPC, RG&E and MI do not oppose staff’s conclusion that LDCs should exit the merchant function.

Of the seventeen supporters, five are gas marketers who believe that a five year transition period is too long. Several suggest that a two to three year transition period would be adequate. On the other hand, RG&E and MI state that a five year transition period may be too short and that elimination of the merchant function must be coordinated with expiration of upstream capacity contracts to minimize stranded costs.

The second largest group of commentators did not directly support or oppose staff’s fundamental conclusion. Seven of these twelve commentators (including four pipeline companies, NYGAS, NRDC, and a marketer) were completely silent on this threshold issue. The other five commentators that did not address staff’s conclusion (two pipeline companies, two LDCS, and a marketer), focus instead on a number of specific concerns that they feel need to be addressed. The pipeline companies emphasize the critical need to ensure system reliability as well as continued access to the interstate pipeline system. According to O&R, staff’s report lacks clearly defined goals and raises a number of operational concerns. The comments of the marketer focus on why it believes unbundling is not working.

Several commentators believe that staff’s fundamental conclusion is linked to its disappointment with the slow progress of customer migration. NYSE&G states that staff perceives the current unbundling effort to be a failure and "surprisingly focuses on the merchant function of the LDCs as a significant barrier to the growth of small customer aggregation". O&R and other commentators note that "as staff itself recognizes, despite an ongoing restructuring process marketers to date have not shown a great deal of interest in the residential market". Con Edison states that "where such disinterest is shared by a large number of customers, the Commission must seriously question hosting a "shotgun wedding".

Conversely, Enron states "If the Commission does not take the next step, as FERC[1] did in Order No. 636, the market will likely stagnate at the 3-5 percent conversion level... Similarly, MC2 "...supports an open market ... To achieve that goal, however, ... the market must be free from unnecessary barriers". MC2 has routinely proposed the following five-point test to determine the extent to which a market is effectively competitive:

"(1) Are there competitive barriers inhibiting competition?

(2) Is there cross-subsidization from regulated markets to deregulated markets?

(3) Do governmental incentives encourage uneconomic behavior by regulated entities, such as LDC retention of pipeline transportation and storage capacity even after they lose customer load to competitors?

(4) Are there services remaining to be unbundled?

(5) Do LDC affiliates receive preferential treatment, including unfair access to LDC marketing information?"

1 FERC is the Federal Energy Regulatory Commission.

Two LDCs question the extent to which, as a practical matter, unbundling will proceed. St. Lawrence notes that it has no small (aggregation) transportation customers which it attributes to its small size and remoteness. NFG states that its "system consists of numerous small, geographically dispersed systems serving local, non-contiguous markets or "island markets". In fact, some of them are served by only one pipeline and so are subject to market power issues should only one marketer elect to serve them."

A number of other commentators are concerned that regulatory policies not be adopted that "force" a new framework for the provision of retail natural gas service on an non-accepting consuming public. For example, Brooklyn Union believes that while staff's proposed five year transition period to a fully unbundled merchant and transportation function is reasonable, it is premature to establish a rigid schedule of transition at this time. Lilco states that an LDC exodus must be embraced by the market. According to Brooklyn Union, "the consuming public must be convinced that the staff articulated objectives of more choice and lower prices and the maintenance of service quality and reliability are indeed likely outcomes of the transition..." Similarly, Con Edison cautions against adopting a "field of dreams" mentality, that is , "if we build it they will come".

NFG is concerned that further restructuring of the gas industry could become subordinate to electric restructuring. NFG states that care is required to protect the positive developments that have occurred on the gas side, and cautions against a "one size fits all" approach. Con Edison also cautions that adoption of a "cookie-cutter approach" must be avoided.

Brooklyn Union states "... resolution of ... whether or not LDCs can or should be required to cease providing merchant service - requires the establishment of a framework of fundamental principles that will apply during and after the transition." Briefly summarized, these are:

- LDCs have ultimate responsibility for distribution system reliability, planning, and operation.
- LDCs must have a fair opportunity to recover all prudently incurred costs.
- LDC affiliates must be permitted to operate in their parent company’s service territories.
- Legislation is needed to relieve LDCs of certain obligations.
- Elimination of the disparity in taxation of various fuels.
- Unregulated merchants must be able to demonstrate that they have sufficient firm supplies for design day needs.
- In the new model, merchant service must be available to all firm customers who now qualify for sales service.
- The obligation to serve less desirable customers must neither unfairly burden some market participants nor disadvantage natural gas compared to other fuels.

Finally, five commentators disagree with staff’s conclusion. Of these, three are LDCs (NYSE&G, Con Edison and Corning) who want to remain in a merchant business to at least be a choice available to consumers who are not interested in pursuing other gas suppliers. A substantial portion of their opposition appears to be conditional. For example, while Con Edison opposes a generic requirement for LDCs to exit the merchant business at this time, it does not oppose a voluntary plan by any LDC to terminate its merchant function. NYSE&G and Corning claim that action to remove LDCs from the merchant business is premature and that the market should be allowed to develop naturally.

NYSE&G[1] states that "In essence, the Paper calls for

[1] Staff notes that NYSE&G, the most ardent supporter of LDCs remaining in the merchant business is in a unique position. NYSE&G is subject to a hard price cap (which includes gas commodity and utility service costs). Unlike other LDCs who flow gas costs changes on a dollar-for-dollar basis through the GAC, NYSE&G with aggressive marketing efforts can earn a

LDCs to abandon their existing customers by "slamming" them to alternative suppliers which they have not chosen, and, by staff's own admission, have shown little interest in providing them with service." In addition, five individual NYSE&G customers disagree with staff's conclusion. They feel comfortable purchasing gas from NYSE&G, consider NYSE&G to be a competitive supplier, and want NYSE&G to remain a gas supply choice available to them[1]. Similarly, Corning states "staff's proposed requirement totally ignores the possibility that customers may be happy with the service provided by LDCs and may not want to change suppliers ..."

PULP claims that staff's report lacks any "legal analysis" and that staff failed to consider whether its fundamental conclusion is consistent with existing laws. According to PULP, the staff report fails to consider whether the Public Service Law gives the Commission the authority to prohibit LDCs from supplying gas or even whether it could allow an LDC to voluntarily exit the merchant function.

The Preservation Coalition of Erie County expresses a distrust of deregulated energy markets and fears that NFGD would be less attentive to preservation of The Gasworks, an official National and City of Buffalo Landmark, under staff's proposal.

Analysis

The vast majority of commentators either support or are indifferent to staff's fundamental conclusion that the merchant and distribution functions should be separated over a five year period. This is interesting and somewhat surprising given the profound impact that this direction would have on the future structure of the gas industry in New York.

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profit on its gas commodity sales.

[1] These customers comments mirror those submitted by NYSE&G.

Two primary issues have been raised in opposition to Staff's fundamental conclusion: (1) it is contrary to customer choice; and, (2) there are legal impediments.

The first issue comprises the key policy question: should LDCs continue to be a gas supplier choice available to customers? Those in support of LDCs remaining in the merchant business advance four arguments:

(1) The market is not sufficiently developed to offer customers an array of competitive choices.

(2) There is insufficient evidence that a competitive market will actually develop: customers are not really interested in making the choice, especially smaller usage customers where the potential savings are either small or non-existent.

(3) It would be wrong to force a change on customers who are not ready or willing to change.

(4) LDCs must remain in the merchant business to assure proper system operation and reliability.

The first argument raises a question of timing as opposed to policy, and thus should not stand as a bar to actions that promote change. Even commentators who oppose staff suggest that at some later date, the market may be mature enough to consider requiring utilities to exit the merchant function. The second argument highlights the uncertainty that a completely unbundled, competitive retail natural gas market is feasible. As of June, 1998, after two years of experience, small customer aggregation participants total approximately 35,800, less than 1 percent of New York's 4.4 million gas customers. Some commentators believe that this experience demonstrates that there is not much interest on the part of both marketers and customers. Conversely, Enron a major marketer who supports staff's conclusion, agrees that the market will not reach that stage of maturity unless staff's proposal is adopted[1]. Staff believes that both viewpoints may be valid; the customer migration experience to date may be due to both barriers to marketer entry and barriers to LDC exit. Some of these barriers are already being addressed. Staff is working to streamline the LDCs' marketer certification process and to improve and simplify their customer application process.[2]

The third argument appears to raise more substantive policy concerns. Some commentators view staff's direction as distinctly different from what has been done in the electric arena. While electric generation assets are being separated from transmission and distribution, the utility will, at least for some time, retain the merchant function (purchasing and reselling power). As a practical matter, for the next several years both gas and electric competitive activities will follow parallel paths, with the utility remaining as a supplier choice. However, staff's proposed end-state for gas is different from electric because LDCs would no longer provide merchant service.

We acknowledge that the inability to remain with their familiar, traditional gas supplier will develop the need for better customer education and care during the transition period which must be of sufficient length to accommodate this change. As discussed later, the Commission has already initiated an effort to identify consumer awareness and informational needs.

We believe that while excluding LDCs from the merchant business will eliminate one choice of gas supplier available to customers, that action must be weighed against the potential harm

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1 Staff notes that while ENRON supports staff's conclusion, other statements the company has made indicate that it has no plans to serve the small residential market.

2 Staff is also continuing to explore the tax differentials that may cause inequities in natural gas competition. While some progress has been made, such as the reduction in Gross Receipts Tax of about 1 % by January 2000 when fully implemented, other tax issues are still being considered.

to the development of competition from allowing LDCs to continue to dominate the supplier function. Staff believes that if the LDC transition out of the merchant business is properly made, the result will be more choice for customers.

The fourth argument is that staff's proposals will threaten reliability[1]. The issue of maintaining reliability is addressed under recommendation 1(c), below.

Staff acknowledges that it will not be easy for LDCs to completely exit the merchant function and a five year transition period may not be adequate in some cases because of longer contract commitments and/or a large number of small customers that may not migrate. We have identified a numbers of barriers that must be removed for this to occur. Further, we believe that there are some customers who, because of their low consumption levels, may not benefit by switching gas suppliers. However, we believe the enhanced competitive environment that will result from further unbundling will expand the range of choice, exert general downward pressure on elements of utility service that can be provided on a competitive basis, and yield synergy savings through the provision of a combination of services through one supplier (e.g., gas, electric, telephone, etc.) that will benefit customers.

Some commentators believe that the market should be allowed to continue to develop "naturally" and that it is premature to take such a dramatic action. Staff agrees that dramatic change should be approached cautiously. However, we strongly disagree with a "let things develop naturally" approach to the extent that it may be read to imply that the current state of market development is acceptable and that LDCs should not plan for competition and take actions to avoid future stranded cost problems. The Commission has clearly stated that LDCs should be

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[1] This is a curious argument, because staff's recommendation specifically stated that LDCs should eliminate capacity except for that needed for SOLR or system operational considerations.

working to move the market in order to minimize potentially strandable costs[1].

Staff’s Position Paper is forward looking and should be viewed in the context of a rapidly changing industry. Staff believes that electric restructuring will generally result in increased marketer interest in the New York energy market and thus will help spur development of a competitive New York gas market. Staff found that the role of LDCs as merchants will diminish over time and that LDC’s existing contracts for upstream capacity will soon start to expire. It is clear that this developing situation must be addressed now so that LDCs can plan properly and make rational, informed decisions regarding capacity contracts. This is critical to minimize potentially strandable costs.

Finally, commentators who disagree with staff’s conclusion generally did not squarely address the benefits identified in staff’s Position Paper from separating the merchant and distribution functions:

- Eliminate the fundamental incompatibility between the existence of regulated LDC merchants and an increasingly competitive gas commodity market.

- Ensure that natural gas is provided on a competitive basis.

- Resolve "level playing field" issues between LDCs and other merchants currently embodied in existing bundled sales services.

- Eliminate the need to regulate LDC gas purchases.

- Parallel FERC action which separated the merchant and transportation functions in the pipeline industry.

The second issue concerns legal impediments.

Staff believes that LDCs should continue to be the provider of last resort for gas service, at least for the short

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

term while other options are more fully explored and developed by staff and other interested parties. Any legal issues related to Supplier of Last Resort or Home Energy Fair Practices Act obligations should be addressed jointly with electric and do not prevent further movement in that direction.

Revised Fundamental Conclusion

The most effective way to establish a competitive market in gas supply is for the LDCs to exit the merchant function. That policy should be implemented taking into account statutory requirements and the needs of each LDC including, capacity contract expiration schedules, rate plan (either existing or to be developed), the state of market development, and other relevant factors, with the five year "target" timeframe modified accordingly. The LDC should 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 other interested parties.

Staff Recommendation (1a)

LDCs should plan to eliminate or restructure any capacity contracts extending beyond 5 years, so as to eliminate LDC obligation beyond that point except for capacity that may be required for SOLR or operational considerations. This will provide a "market test" to determine marketer interest and establish the value of capacity as well as the magnitude of stranded costs. Staff's preferred approach is to sell the contracts at auction(s). Such a plan would also involve treatment of stranded costs.

The Commission previously directed LDCs to encourage development of the competitive supply market and customer migration so that they do not need to replace expiring capacity contracts. As a first step, LDCs may want to focus on encouraging firm commercial and industrial customers to switch to other merchants.

Summary of Comments

Nearly all of the commentators focus on three aspects of this recommendation: (1) staff's preference to sell the contracts at auction; (2) the issue of stranded costs; and, (3) the proposed five year timeframe.

Auction of Capacity - The vast majority of comments, including all of the comments from LDCs and pipeline companies, either oppose or question the proposed auctioning of capacity contracts. Several LDCs (Con Edison, Corning, O&R, RG&E, and NYGAS) state that auctions will create a buyers market and depress prices for capacity.

Another group of commentators (Brooklyn Union, IGTS, NMPC, NFGD, TETCO/AGT, and TGPL) state that auctions will not work because FERC rules prohibit the sale of capacity for more than maximum tariff rates.

NYSE&G opposes the use of auctions until SOLR issues are addressed. Two pipeline companies (CNG Trans and TGPL) emphasize the need for LDCs to continue to control storage and the pipeline capacity needed to delivery the gas from storage.

A number of marketers oppose or question the use of auctions. Eastern and Enserch favor negotiations over the use of auctions. MC2 prefers mandatory assignment of a pro-rata portion of transportation and storage capacity to customers during the transition to a competitive market.

Empire and Iroquois express similar concerns with the use of auctions. Both of these pipelines were project-financed with the contractual commitments of LDCs and other customers providing the basis for financing. These commentators caution against actions that would sever these contractual arrangements or conflict with FERC rules.

Enron states that an auction is not necessary to determine marketer interest or capacity value, because a framework for an open capacity market already exists under FERC rules. Enron also cautions "Nor should the Commission assume that the auction process is as applicable to natural gas pipeline capacity as to electric generating plants." Enron believes that the problem will solve itself in the long run, but in the interim, marketers should have the option to take a share of capacity needed to serve the converting customers. Enron also believes that mandatory assignment of capacity would be self defeating and a substantial barrier to entry.

All of the commentators who support staff are gas marketers (AMOCO, MAC, PG&E, WEPCO). Finally, six commentators (CNG ES, CPB, NRDC, NAU, PCEC and PULP) did not comment on the proposed use of an auction process aspect of the recommendation.

Stranded Costs - A significant number of commentators including most LDCs have strongly held views on stranded cost issues. Eight LDCs (Brooklyn Union, Con Edison, Lilco, NFGD, NMPC, O&R, RG&E, and NYGAS) argue that partial passthrough is unacceptable and that LDCs should be allowed to recover any cost incurred to meet their service obligation. MAC also supports this position. As Brooklyn Union states, "LDCs must be assured a fair opportunity to recover prudently incurred costs of all upstream supply and capacity. LDCs cannot be penalized for incurring costs, with the approval of the Commission, required to provide the level of service needed to fulfill their public service obligations, and then needing to shed those costs resulting from the transition to a fully separated merchant function, which separation is promoted and advanced by the same Commission."[1]

Most other commentators did not address the stranded costs aspect of this recommendation.

Five Year Transition Period - As reported earlier, five gas marketers believe that a five year transition period is too long and several suggest use of a two to three year transition period. On the other hand, some commentators are concerned that a five year transition period may be too short and that elimination of

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[1] Staff notes that while the Commission may have had knowledge of costs incurred by LDCs, it did not give its "approval".

the merchant function must be coordinated with expiration of upstream capacity contracts to minimize stranded costs. Empire and Iroquois, the project-financed pipelines would like a transition period that corresponds to the contractual commitments of their customers.

Most commentators did not comment on the proposed five-year transition period aspect of the recommendation.

Analysis

Auction of Capacity - Many of the commentators identified a number of problems under current FERC rules with the use of auctions and there appears to be little support for this approach to reduce LDC contract obligations.

The commentators argue that at this time auctions would not serve to discover price because FERC rules limit the price that can be offered for capacity[1].

There are a limited number of options for an LDC to reduce capacity contracts. Other than the FERC capacity release program there are direct negotiations with marketers. Also, several LDCs have entered, or may be considering, capacity management agreements with energy companies. Under such agreements, LDCs retain the upstream capacity contracts until they expire. These agreements would increase that energy company's familiarity with the market area and thus may increase its interest in acquiring capacity to serve that market in the future. However, the agreements raise offsetting market power concerns including the ability of that player to control the capacity needed to serve a market area and the potential for preferential treatment of that company's affiliated marketer.

Thus, staff believes that at this time given current FERC rules, auctions have limited value. Namely, there is a

[1] FERC has since proposed removal of that price cap. See Notice of Proposed Rulemaking, Docket No. RM 98-10-000, issued July 29, 1998.

chance that through an auction a purchaser may be willing to pay some premium for the assurance of long term access to capacity instead of the vagaries of relying on acquiring capacity on a month-to-month basis via the secondary market. However, it appears that adoption of the portion of FERC's recent proposal that would remove the rate cap on released capacity would change the situation significantly and warrant reconsideration of an auction approach.

<u>Stranded Costs</u> - Staff's Position Paper states:

> "Stranded cost recovery/sharing will be addressed on an individual company basis: ... The LDC plans should address treatment of strandable costs. Partial pass-through should be considered and settlements encouraged."

These statements were not intended to suggest that LDCs should be denied recovery of prudently incurred costs, but rather reflect two concerns. First, in the context of a proposed auction we wanted to avoid a posture that could influence the behavior of potential bidders.

Second, stranded costs issues relate not only to existing capacity contracts but also to future capacity arrangements. Thus, in staff's view the treatment of stranded costs needs to consider both the LDCs' expectation to recover costs incurred to provide their service obligation, and the need to minimize continued exposure to such costs. In other words, if an LDC does little to move the market it could argue that when existing contracts expire they must be renewed. But renewing contracts will create unnecessary exposure to additional potential stranded costs, the recovery of which would be questionable.

Conversely, if an LDC takes aggressive action to minimize strandable costs, full recovery of the mitigated strandable costs would seem to be appropriate. Staff proposes that at a minimum the criteria for evaluating whether aggressive actions have been taken include a demonstration that the LDC has minimized such costs in compliance with the Commission directives in Case 93-G-0932[1].

The intent of the LDC's April 1998 filings was to inform the Commission of the options that are being evaluated and pursued to mitigate strandable costs, including alternative uses and market values for capacity and collaboration with marketers. Staff believes that stranded costs do not appear to be a significant problem until the 2002-2008 timeframe, are concentrated in the greater New York Metropolitan area, and if innovative actions are taken, would be manageable. Some companies appear to have no strandable costs, or only minor amounts of strandable costs.

Staff believes that capacity assignment is a significant barrier to competition and should not be allowed after April 1, 1999[2]. Marketers should be allowed to bring their own capacity to pursue efficiencies in upstream markets to better serve customers. The two LDCs[3] with the most successful aggregation programs do not require the assignment of upstream capacity to customers.

Five-Year Transition Period - Another element of this staff recommendation is the five year transition period for LDCs to exit the merchant function. The range of alternatives identified by the commentators is from two years to allowing existing contracts to run their course (some extend until 2014).

We agree with the suggestion that the Commission should avoid a rigid solution applied to all LDCs and where appropriate, should harmonize the transition with the expiration of contracts.

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[1] Specifically, the requirements of the Order Clarifying the April 1998 Excess Capacity Filing Requirements, issued September 7, 1997.

[2] Properly mitigated strandable costs should be recoverable. For example, the costs could be spread over all system sales and firm transportation volumes.

[3] Brooklyn Union and Con Edison.

We believe that the best approach would both encourage development of a competitive market and accommodate existing contracts to the extent possible.

Also, there are a number of proposals to expand capacity to the Northeast. If additional capacity is constructed, it may lower the value of capacity held by LDCs on the secondary (capacity release) market. These developments must be monitored and considered.

Revised Recommendation

LDCs should develop plans to eliminate or restructure capacity contracts as soon as possible.

Capacity assignment is a significant barrier to competition and should not be allowed after April 1, 1999.

The desirability of auctions should be revisited in the future, especially if FERC changes its rules.

LDCs will be provided a reasonable opportunity to recover strandable costs if they can demonstrate compliance with the Commission directives in Case 93-G-0932 to minimize such costs.

Staff Recommendation (1b)

The Commission should develop a policy to allow the Supplier of Last Resort/Obligation to Serve functions to be provided by any and all merchants who want to serve the market, provided that all statutory requirements are met.

Summary of Comments

Nearly all of the comments on this recommendation are from LDCs or marketers.

Several comments were received on the definition of the term SOLR. Con Edison states "Staff uses the term "Supplier of Last Resort" or "SOLR" instead of "Provider of Last Resort" or "POLR", which was the term used by the parties to the collaborative process involving electric cases. The Company agrees that SOLR is a more apt term, since only a change in the LDC's obligation as a merchant is at issue. As the Commission noted in Opinion No. 97-5, the responsibility to connect and deliver electricity remain monopoly functions; the same is true for gas utilities.

Amoco suggests changing the term to "obligation to deliver". Corning comments that the staff report does not attempt to identify those customers for whom a SOLR would be required. Similarly, O&R states "Initially, it must be determined what responsibilities are included within the SOLR/OTS roles."

The critical need to address this issue and the fact that it is inextricably intertwined with the overall thrust of staff's Position Paper is highlighted by several commentators. NYGAS states "Given the impact on upstream capacity contracts of any PSC mandated LDC retention of SOLR responsibilities, it is essential that this responsibility be defined and quantified as quickly as possible in order for LDCs to proceed with their planning, and prior to implementing any LDC exit from the merchant function." Corning, NMPC and NYSE&G make the same point.

The issue of existing regulatory authority and the need for legislative change was raised by several commentators. NYGAS states "Also, Commission policy, by itself, is insufficient to legally relieve LDCs of their SOLR responsibility. Public Service Law, The Transportation Corporations Law and common law practices impose requirements on LDCs which cannot be abrogated by a Commission policy." O&R states "...some of the duties that may be included within these roles are ... statutorily required. No regulatory action should be taken with respect to reallocating these statutory SOLR/OTS duties until necessary legislation has been enacted to relieve LDCs of these obligations." Corning and NMPC also state that legislative action is needed. PULP's position is that all marketers are gas corporations and are therefore subject to HEFPA. Corning and Lilco suggest further study of this issue.

NYSE&G states that LDCs acquired capacity assets to meet the SOLR obligation, and "... is one factor that significantly limits the LDC’s ability to reduce upstream capacity." NYSE&G also cautions that shifting SOLR responsibility to marketers will reduce their price advantage and thus slow the market transition.

Five marketers (Amoco, CNG ES, Duke, Enron, and MAC) and one LDC (NFGD) support the view that the SOLR function should be open to competition, and should be auctioned to a third party.

In contrast, two LDCs argue that the function is not needed in a competitive market. Con Edison states "Staff has not demonstrated a need for an SOLR in a fully competitive market .... The Commission has consistently and correctly viewed HEFPA as intended to establish procedures for the customers of a monopoly provider, not participants in a competitive market". Similarly, NMPC states "In a truly competitive market place there is generally no appointed supplier of last resort."

Con Edison states "The one SOLR alternative that does not require the designation of a specific supplier required to provide service to all or selected customers is the creation of a tax-supported government program to assist eligible customers in their ability to pay. A voucher program, which the Energy Association has proposed and supported in the ESCO collaborative process (Case 94-E-0952) should meet the Commission’s consumer protection objectives ...".

<u>Analysis</u>

Staff appreciates Con Edison’s distinction between SOLR and POLR. However, we believe that the issues and solutions for gas and electric are similar enough to warrant the use of the term POLR for both. Staff believes that a more precise definition of POLR functions would help clarify the discussion of this issue. The following functions are often considered to fall within the POLR obligation:

(1) Attach customers to the distribution system.

(2) Provide gas in the event of supplier non-performance during short periods of time.

(3) Provide gas supply to customers who do not chose a gas supplier or to customers whose supplier does not perform on a long-term basis.

(4) Provide balancing services.

(5) Provide gas service to payment-troubled customers.

Staff considers the attachment of new customers and the provision of balancing services to be LDC functions. However, in the future it is conceivable that a marketer might want to construct a line to develop gas service in a new area or may want to provide balancing services. We consider the issue of providing service to payment-troubled customers to be a social program issue, which is discussed under recommendation 6, below. Thus, the POLR functions of interest here are providing a backstop for marketer non-performance on both a short and long-term basis.

With regard to the legal impediments raised by a number of commentators, staff believes there may be opportunities within existing law to have the service obligation provided by non-LDCs. It may be possible, for example, for LDCs to establish a third-party default provider, while remaining ultimately responsible for providing service. Such opportunities should be explored and resolved in collaboration with the electric restructuring proceedings.

In the O&R electric restructuring settlement[1] the Commission determined that the POLR responsibility should, for the time being, continue to be performed by the regulated utility. However, the Commission did not rule out alternatives

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[1] Case 96-E-0900 - In the Matter of Orange and Rockland Utilities Inc’s. Plans for Electric Rate/restructuring Pursuant to Opinion 96-12. Order Adopting Terms of Settlement, Issued November 26, 1997.

to regulated utilities performing this function and specifically invited such alternative proposals. In that case the parties agreed that the transfer of the POLR responsibility to ESCOs through a competitive bid process is a desirable goal to explore.

The comment that there is no need for a POLR obligation in a fully competitive market view is an issue that is not ripe for consideration at this time, but should be reexamined as the market develops. The suggested use of a voucher program is an issue for the legislature that may have some appeal but seems unlikely to occur and goes beyond the Commission’s authority.

Revised Recommendation

The Commission should resolve POLR issues in collaboration with the electric restructuring proceedings.

Staff Recommendation (1c)

System Reliability - Prime reliance should be placed on market based solutions. The best way to assure system reliability is to establish a robustly competitive market. Providing opportunities for marketers to bid on and acquire the upstream capacity now under contract to LDCs and cooperative arrangements between LDCs and marketers can facilitate development of such a market.

Summary of Comments

Generally speaking the comments make it very clear that system reliability is a critical issue and that great care must be taken to assure continued reliable system operation and performance.

The most frequent comment is that system reliability should remain an LDC function. This view is expressed by most LDCS, NYGAS and one marketer, with varying emphasis on different aspects of this position. For example, Lilco states that LDC involvement is paramount during the transition, RG&E states that a single point of control is needed, NYGAS states that the

Commission should determine how much capacity LDCs should retain for this purpose, and NYSE&G states that marketers have not shown a willingness to serve under adverse conditions.

Several commentators state that staff's view is too simplistic or idealistic and does not recognize the realities of the marketplace. TGPL states "... an unfortunate component of competition is the failure of certain market participants." Corning states "To assume that the same reliability will exist with a collaborative effort between LDCs and marketers is a leap of faith at best .... This could result in a duplication of capacity that will only raise the cost to the small customer." Con Edison strongly disagrees with staff's suggested approach "And even if staff is correct that a competitive market will self-correct, the potential consequences to the integrity of the LDC's distribution system during even a brief correction period do not justify such reliance". O&R states that more than competition will be needed to assure reliability. PULP states that reliability will suffer under staff's proposal.

Brooklyn Union states "... in order to ensure that system reliability is not jeopardized under a model that would have merchant service provided only by unregulated suppliers, customers, LDCs and suppliers will have to reach agreement, as was the case when interstate pipelines unbundled their systems, on a set of rules and tools that can accomplish this objective." MC2 "... supports the imposition of substantial penalties for non-performance as a means to compel third party suppliers to meet their contractual obligations."

O&R states "that...... capacity must be guaranteed for customers ... suppliers need firm upstream capacity with O&R's city gate delivery points as primary delivery points under those contracts in order to provide reliable gas service to its customers. There is simply no guarantee that marketers serving New York customers will be the successful bidders if New York LDCs auction their upstream capacities."

NYSE&G is seriously concerned by staff's "...

dismissive response to the many potential system reliability and operational integrity concerns which will surely arise if staff's recommendations are pursued" and warns "The Commission's authority to respond to unwarranted or unintended outcomes will be reduced substantially, if not eliminated, in a market consisting solely of non-regulated merchants."

CNG Trans comments highlight the importance of no-notice service to assuring system reliability. Its marketing affiliate, CNG ES further states that "unbundling of storage to the retail level will affect current flexibility by eliminating the means for managing LDC system swings and imbalances and introducing both the risk of operational problems and the loss of existing efficiencies. CNG ES encourages the Commission to actively study and participate in developing solutions to this and other reliability issues". TETCO/AGT states that continued access to the interstate pipeline grid is needed to assure reliability.

Several commentators suggest the use of an Independent System Operator (ISO) to address reliability concerns. Con Edison states "Staff seems to ignore the fact that the establishment of an ISO and power exchange are critical aspects of both FERC's and the Commission's electric retail access model ....". NYGAS states "The Commission's requirement for Energy Service Companies (ESCOs) serving electric customers in New York State include proof that the ESCO has met all applicable requirements of an independent system operator (ISO), who will be establishing capacity requirements to replace and/or supplement local reliability rules."

While many commentators warn that staff's proposal will threaten reliability, PG&E provides a different perspective "... although there was pervasive hand wringing prior to the issuance of Order 636 that a wholesale transition to competition would not benefit small customers and would damage reliability, those dire predictions are no longer heard because even small customers have reaped numerous benefits from wholesale competition."

Two gas marketers support reliance on the market to assure reliability. Enron "strongly supports staff’s proposed plan to rely on market forces. We agree that collaboration between LDCs and suppliers is critical ... Enron prefers reasonable tariff guidelines to efforts to regulate suppliers directly.... The catch ... is a potential disagreement between suppliers and LDCs with regard to the appropriate level of capacity. The staff could play a key role in such collaborative negotiations." Amoco totally concurs with the prime reliance on market based solutions.

Some eleven commentators were silent on this recommendation.

<u>Analysis</u>

A number of commentators believe that staff places too much reliance on an undeveloped market and too little importance on credible measures to assure system reliability and performance. As stated above, this is a curious argument since staff’s recommendation specifically stated that LDCs should eliminate capacity <u>except for</u> that needed for POLR or system operational considerations. These commentators should be assured that staff will not accept, nor would the Commission tolerate, anything that would seriously compromise system reliability and performance.

A basic question that will emerge as the portion of upstream capacity controlled by LDCs diminishes and the number of merchants and their share of the market expands, is how will the operation of distribution systems change? A better understanding of such changes will facilitate how the following concerns should be addressed:

- What is the best way to insure reliability of service to core customers and maintain system operational integrity?

- What is the best way to provide the POLR function?
- What is the best way to address market power issues[1]?

Some parties have suggested that an Independent System Operator (ISO)[2] would be a useful way to address these concerns. Opinions vary on the exact purpose and function of an natural gas ISO. While an ISO is being implemented for electricity[3], staff questions its applicability to natural gas at this time. The natural gas delivery system is not centrally dispatched, as is the New York Power Pool, with each LDC operating independently[4].

We believe that an examination of how the operation of the gas distribution systems will change in the future is needed. A collaborative process, which includes staff, LDCs, marketers and interstate pipeline company representatives, should be established to conduct this examination and address future system operation through development of appropriate procedures,

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1 A holder of upstream capacity could use control of such assets to provide an advantage for itself or affiliates.

2 The system operator function is currently performed by LDC gas control and dispatch personnel. This function includes: ensuring that system pressures are monitored and maintained within appropriate operating levels; monitoring system demands and gas deliveries to ensure that adequate supplies are available to meet requirements; scheduling gas deliveries where needed on the system; system balancing (dispatching additional storage withdrawals or peaking supplies as needed when system demands exceed scheduled deliveries); interruption of interruptible customers as needed; coordination with the pipeline system operators to ensure that everything functions smoothly; and, responses to emergencies.

3 FERC required the establishment of electric ISO as a prerequisite for market based transmission pricing.

4 The one exception is the New York Facilities System, a transmission loop that surrounds the New York City - Long Island market area and is jointly owned and operated by MarketSpan (Brooklyn Union, the former Long Island Lighting Company) and Con Edison.

protocols, and information systems to assure reliable system operations.

Revised Recommendation

No compromise in system reliability will be permitted. LDCs will be allowed to hold assets needed for proper system operations. A collaborative process should be initiated to examine and address future system operation issues[1].

Staff Recommendation (2)

Continue to review rate design issues to identify changes required to eliminate subsidies and promote a competitive market. Appropriate changes should be implemented on a company-by-company basis.

Summary of Comments

Some seven commentators (Brooklyn Union, Con Edison, Lilco, Enron, Enserch, MC2 and MI) agree with staff’s recommendation.

Lilco states "However, cross-subsidy elimination proposals that are economically sound are generally at odds with the reluctance to implement meaningful rate reform. To ensure viable rate reform, the Commission is urged to establish a definitive time-frame ... consistent with the time-frame for the restructuring of the gas industry." LILCO also urges the Commission to support repeal of PSL section 65(6), which prohibits charges for specific services with limited exceptions. LILCO claims that these limitations inhibits LDC unbundling of the cost of those specific services, which LILCO believes should be borne by those customers requesting particular services instead of the general body of ratepayers.

[1] Through development of appropriate procedures, protocols, and information systems.

Another group of four commentators (Duke, NAU, RG&E, and WEPCO) state that rates should be cost based, which is also supportive of staff's recommendation. Amoco states that rates should be designed to encourage marketer entrance.

Four commentators (CNG Trans, CPB, NFG, and PULP) warn that some rates will increase as a result of staff's recommendation, particularly those for residential customers. NFG cautions "...most subsidies are the result of public policy choices .... does New York truly wish to remove all subsidies and significantly raise the rates of small commercial and residential customers? .... It is important to keep in mind that subsidies are not necessarily bad when they are in the public interest. Consequently, staff and the Commission should be open to the possibility that some subsidization might continue."

NMPC states "As the LDCs exit the merchant function, they will lose control of the commodity price. If commodity prices rise, the result could be reduced throughput ... which would reduce the LDC's profitability. Thus, rate design changes such as Straight-Fixed-Variable (SFV)[1] used for interstate pipelines may be more appropriate where LDCs are no longer serving the merchant function.

Finally, some fourteen commentators were silent on this recommendation.

Analysis

As a general proposition, staff seeks an overall reduction in gas costs to customers. Establishing competition in the gas supply market will increase overall customer savings, exert general downward pressure on elements of utility service that can be provided on a competitive basis, and yield synergy savings through the provision of a combination of services (e.g.,

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[1] SFV rates recover all fixed costs through a demand charge (i.e. costs are paid regardless of throughput). Variable costs are recovered through the commodity component of the bill.

gas, electric, telephone, etc.) that will benefit customers. The functions most often cited as being potentially competitive are metering, billing and information systems (MBIS). Staff supports further unbundling of rates to identify the costs associated with specific service elements as a means to promote competition for the provision of same.

Staff agrees that while elimination of subsidies is a worthy goal it may entail impacts that make it difficult to accept and implement. Some changes have been implemented for several LDCs with changes in customer charges phased-in over several years. The customer impact of these changes is an important factor that tempers the acceptable pace of change. The impact of the elimination of subsidies on customers must be weighed and balanced against the extent to which such changes would promote competition.

The Commission has already initiated two rulemaking proceedings that will impact rate design. The first is a rulemaking to change the gas cost recovery mechanism know as the gas cost adjustment clause (GAC)[1]. The proposed rule changes, if adopted, among other things, would result in the separation of distribution and gas costs (commodity and upstream capacity costs), and allow gas costs to be assigned to customers more accurately, based on the customer's pattern of use (load factor). That would result in an increase in gas costs assigned to low load factor customers, such as residential space heating customers, and lower gas costs assigned to higher load factor customers such as commercial and industrial customers. From a marketer's perspective, this would increase the attractiveness of

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[1] Case 97-G-1178 - In the Matter of the Rules and Regulations of the Public Service Commission, Contained in 16 NYCRR, Chapter III, Gas Utilities, Subchapter D, Rates and Charges, Part 270, Construction and Filing of Tariff Schedules - Proposed Amendments to the Commission's Gas Cost Adjustment Clause Regulations Contained in Section 270.55, filed in C 21656.

the low load factor market while reducing the profit margin associated with service to higher load factor customers.

The second proceeding is a review of the Commission's policy on negotiated rates for the pricing of gas transportation to electric generation facilities[1].

Staff agrees with the comment that the timeframe for implementing rate design changes should be consistent with the timeframe for restructuring of the gas industry.

Staff disagrees with the concept that the LDCs risk of profitability will increase when they exit the merchant function because they will lose control over gas prices and could experience decreased throughput if prices increase. Staff believes that there would be little change, and perhaps an improvement, in relative risk of price volatility. However, with respect to price levels, we acknowledge that a competitive market could result in higher prices for some customers, resulting in decreased throughput. This risk would be offset by other changes in the market including potentially lower prices and increased demand for service to other customers.

Finally, institution of other rate mechanisms which would provide impetus for LDCs to encourage development of a competitive market should be considered. For example, the following should be considered: incentives for LDCs to encourage customer migration (e.g., rate-of-return adjustments; elimination of the incentive for LDCs to hold capacity[2]; and, the possibility of a more aggressive role for LDCs in facilitating the move to a competitive market (e.g., aggregating customers for marketers or bidding-out customer segments).

Moreover, removal of barriers may require changes in

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1 Case 98-G-0122 - Proceeding on Motion of the Commission as to the Review of the Commission's Bypass Policy for Gas Transportation to Customers.

2 Generally, the Commission has allowed LDCs to retain 15 percent of off-system sales and capacity release revenues.

current laws or rules. For example, more flexible meter reading requirements could enhance the attractiveness of certain customers to marketers.

Revised Recommendation

A continuing review of rate design issues is needed to identify changes required to promote a competitive market. Rates should be further unbundled, and other changes considered such as the reform of GACs, the creation of incentives and the elimination of barriers to development of a competitive market.

Staff Recommendation (3)

Develop safeguards and monitoring mechanisms for market power issues. The Commission will increasingly face market power issues during and beyond the transition to a more competitive market (e.g., proposed mergers, changed corporate structures and affiliate transactions). These issues will require the adoption of appropriate safeguards and careful monitoring to assure that no player garners undue market power.

Summary of Comments

Four commentators (Amoco, Eastern, ENRON, MI) support staff’s recommendation. Con Edison states that staff should support and encourage the transfer of functions to affiliates. Several gas marketers (Eastern, MAC, MC2, WEPCO) express concern with affiliate relationships.

NYSE&G states that "...market power issues will arise, particularly if the envisioned consolidation of alternative suppliers occurs. Specifically, small, rural customers may once again be faced with only a single supplier since economies of scale make it prohibitive for numerous suppliers to enter markets with limited potential."

NFGD states "... Most LDCs already have marketing affiliates doing business in New York State under perhaps the nation’s most stringent and comprehensive rules of conduct. Not surprisingly, the result has been that utility marketing affiliates often do less business in New York State than elsewhere. ... utility marketing affiliates are important contributors to the development of a competitive market ... As this restructuring proceeds, the Commission should encourage utilities to provide unbundled services through affiliates."

RG&E states that this issue has already been addressed in the COB case. More than half of the commentators did not address this issue.

Analysis

Clearly, natural gas market power issues will arise and must be addressed. Electric market power issues are being addressed in the electric restructuring proceedings. The Commission issued guidelines on horizontal market power[1] and guidelines on vertical market power[2]. In addition, the electric restructuring agreements contains guidelines for affiliate transactions. Other issues being addressed include appropriate data needs and gathering efforts, market power issues in load pockets and the extent to which market power issues can be addressed through the ISO. These efforts are generally focused on divesting ownership of generation in order to create an environment with many sellers to mitigate horizontal market power concerns and separating transmission/distribution assets to mitigate vertical market power concerns.

For natural gas, LDCs do not own the equivalent of generation assets (gas reserves and production capacity). Instead, the LDCs hold contracts for gas supplies and delivery capacity. This presents a somewhat different set of issues, focused more on the 'middleman', especially, the holder of

[1] As an appendix in the O&R auction order, as well as each subsequent order addressing auctions of electric generators.

[2] Case 96-E-0900, et al., Statement of Policy Regarding Vertical Market Power, Issued July 17, 1998.

contracts for delivery capacity. For example, there is the potential for market dominance by a company that could acquire most if not all of the capacity needed to serve a market area enabling it to exert undue control over that market. Further, such a company might have an affiliated marketer, which they may be able to favor, and together exert undue control over the market.

In addition, we believe that there are a fair number of natural gas load pocket areas which will raise market power issues. Finally, unlike electricity, a central statewide ISO is not envisioned for natural gas at this time, so that market power issues will have to be addressed through each LDC's system operation procedures. These issues must be carefully monitored and addressed as the transition to a competitive environment proceeds.

Revised Recommendation

The Commission should continue to develop safeguards and monitoring mechanisms for market power issues in natural gas markets, building generally on how these issues were addressed in the COB cases.

Staff Recommendation (4)

Continue staff review and monitoring of LDC and marketer customer education programs to identify the potential barriers and develop a systematic plan of action for greater accessibility to information and options about choices. LDCs should employ customer research as a basis for developing or continuing customer communications activities. Customer communication and outreach campaigns are essential to ensure customer awareness of the changes in the natural gas market and to encourage active customer participation in the assessment and selection of energy service providers.

Summary of Comments

While no commentator disagrees that more customer education is needed, only two commentators support staff's recommendation, and the majority of commentators were silent. Nevertheless this issue did garner considerable interest as well as sharp disagreement between LDCs and marketers (the only stakeholder groups submitting comments).

Views of LDCs and marketers diverge on what information should be provided, who should provide it, and who should pay for it. Four LDCs (Corning, NMPC, O&R, and RG&E) and NYGAS want to carefully limit the role of LDCs.

NMPC states "Staff recommends that LDCs serve as a clearinghouse resource for providing customers with information about suppliers of the gas commodity. That recommendation should be rejected. There is no conceivable justification for requiring a company, who is not in the business of selling a commodity, to provide information to customers of other companies who do sell the commodity."

RG&E states "LDCs should not ... be required to undertake or pay for advertising marketers' programs. Marketers are the primary beneficiaries of unbundling; there is no reason why they should not be expected to bear their own costs of doing business." The same viewpoint was presented by, Corning, O&R and NYGAS. RG&E also states that the "customer perspective" questions[1] posed by staff are suggestive of the types of issues LDCs should not be required to address.

Corning states "LDCs responsibility ... should be limited to providing information as to the availability of services. The process of educating customers ... to make choices and bear the consequences of their decisions will be very costly, a cost which should be borne by marketers as the ultimate beneficiaries of the movement."

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[1] Will I save money? Am I comfortable making a change?

The comments of marketers demonstrate their concern that LDCs will provide unbiased information. Enron cautions "... that LDCs should not be permitted to undertake marketing programs in the guise of customer education or outreach programs." WEPCO states "As a general matter, we believe customer education programs should be carried out by the Commission and/or independent third parties rather than the LDCs .... as the incumbent service provider ... the LDC clearly has a conflict of interest." MC2 strongly disagrees with the staff recommendation that LDCs be a clearinghouse resource... "LDCs with affiliate marketing subsidiaries, partnerships or joint ventures will have an inherent bias towards 'educating' their customers in favor of such affiliates."

WEPCO recommends that LDCs be required to unconditionally release customer information to all eligible marketers. Eastern states a similar view and also "does not agree with Staff that a communications audit of marketer programs is necessary. The effectiveness of marketer communications can be easily assessed by the market ...". Amoco recommends a collaborative process to address this issue.

Analysis

The comments demonstrate the distrust that LDCs and marketers have for each other. This may portend the difficulties that lie ahead in providing meaningful, and needed, customer education.

With respect to what type of information should be provided, staff believes that customers need information on the changes in the industry and marketers offering services, as well as guidance on how to evaluate various offers. Staff disagrees with the implication that this constitutes advertisement of marketers programs or provides some particular benefit to marketers. The provision of unbiased, accessible information would facilitate customer migration to a competitive marketplace.

The Department of Public Service has initiated a series of surveys to identify consumer awareness levels and informational needs. The results of the surveys will be used to develop education programs about the competitive electric and natural gas markets.

An additional statewide survey is being developed to assess the experiences of customers who have decided to purchase natural gas through marketers and to identify obstacles preventing greater customer participation. This survey is expected to be completed by the end of 1998.

Staff should continue to monitor LDC and natural gas marketer programs to identify potential barriers and provide for greater access to information about choices.

NMPC’s argument that LDCs should not have to provide information about a commodity that they no longer sell completely ignores the fact that LDCs will continue to sell gas until they exit the merchant business. We believe that LDCs must provide customer education as long as they are in the merchant business. Customer communications are essential to ensure customer awareness of the changes in the competitive market, enabling them to evaluate choices and make informed decisions.

It is also clear that there is a significant amount of customer inertia that must be overcome. Elimination of capacity assignment will provide significant savings that can be used to encourage customer migration. The use of "icebreaker" financial incentives, such as the "shopping credit" offered through Con Edison’s retail access program could be considered to facilitate customer interest in alternative suppliers.

Revised Recommendation

Staff should continue to monitor LDC customer communications and education programs and identify vehicles which are most effective in enhancing customer awareness and understanding of the competitive market.

LDCs should employ strategies based on market research and, on an experimental basis, design and implement financial and other incentives to create more opportunities for small customer migration.

Natural gas marketer communications efforts are also useful sources of information regarding how best to reach customers. Staff should continue to seek information on these efforts to: (1) further its own knowledge of market developments and (2) enhance LDC's and the Department's customer education programs.

<u>Staff Recommendation (5)</u>

Refocus regulations as the industry evolves (e.g. market power issues will become much more important, while increased reliance on market forces will reduce the need for traditional regulation). Regulation must become more streamlined and flexible. The performance of new market entrants must be assured without stifling competition. A review of the appropriate treatment of business sensitive information in a more competitive environment is needed.

<u>Summary of Comments</u>

Thirteen commentators support staff's recommendation with many offering specific suggestions regarding the appropriate future direction of regulation. Several commentators state that in the future the Commission should increase efforts to monitor and establish rules for affiliate transactions. Two commentators state that the Commission will have to resolve competitive complaints. Enserch states that the Commission will have to be the "steward of competition". Similarly, MC2 believes that the role of the Commission should be to remove barriers to competition. Enron states that the Commission's role should be to watch LDCs, not regulate marketers.

MI states that the Commission's role should be to ensure cost based rates. NYSE&G identifies an increased need to protect business sensitive information in an increasing competitive environment. Con Edison and NYGAS state that regulators should assume some responsibility for consumer cost reductions.

More than half of the commentators were silent on this recommendation.

Analysis

Regulation must evolve along with changes in the industry as increased reliance on market forces will reduce the need for traditional regulation. At the same time, new issues will arise as the role of LDCs change and new players provide an expanding array of services.

A continuing review and reassessment of the appropriate role of regulation will be needed. Staff believes that regulation has been responsive to the needs of the emerging aggregation market over the last two years. In the future, we believe that the issues that need to be addressed during the transition to a more competitive market fall into two categories: (1) issues to be addressed in a manner consistent with the electric competitive opportunities cases (e.g., market power issues, POLR/HEFPA issues, assuring performance of non-regulated entities, removal of barriers to competition, resolution of competitive complaints, and protection of business sensitive information in an increasingly competitive environment); and (2) issues that need to be addressed on a gas industry specific basis (e.g., capacity contracts, system operations and reliability).

Revised Recommendation

A continuing review is needed to assure that regulation becomes more streamlined, flexible, and refocused as the industry evolves.

Staff Recommendation (6)

Develop a mechanism for funding social programs. These programs should be reviewed to identify possible cost savings opportunities and appropriate legislative changes. Alternative approaches, such as LDCs sharing these responsibilities and/or costs with other merchants (e.g., bidding, risk pools, and payment options) should be developed and market tested before full scale implementation.

Summary of Comments

Approximately half of the commentators support staff’s recommendation, offering varying suggestions on how the social program funding mechanism should be developed.

Several commentators propose alternative funding mechanisms. Enron and NMPC state that social programs should be funded through general taxes, not gas rates. Enserch states that the Commission and the Department of Social Services should create a voucher system; MC2 states that "gas stamps" should be issued. NRDC recommends use of a non-by-passable charge to fund low-income, research, and energy efficiency programs.

Brooklyn Union argues that gas merchants should have no more responsibility than oil dealers. Con Edison believes that charges for social programs should apply equally to sales and transportation service. Eastern states that funding vehicles should not create barriers to competition. Corning supports a collaborative study of the issue.

Lilco and NFG state that such changes may require legislative changes, and NFG suggests that the Commission should review its own regulations to identify costs imposed that are not statutorily required. NYSE&G agrees that existing programs should be reviewed and wants assurance that the burden is distributed fairly among merchants.

PULP states that social programs do not cost the LDC anything since all costs are passed on to ratepayers. O&R argues that no restructuring of the LDC’s merchant role can be required until LDCs are legislatively relieved of their statutory social program obligations.

Nearly half of the commentators were silent on this recommendation.

Analysis

In restructuring electric utility services the Commission established use of a Systems Benefit Charge (SBC) to cover the cost of certain energy efficiency, research, low-income energy efficiency and environmental protection programs, subject to a general guideline of a one mill/kWh cap[1]. The intent is to fund those programs needed to transition to a competitive market as well as those that are not expected to be adequately addressed by competitive markets[2]. Further, the majority of SBC programs have the potential for greater ratepayer benefits and operate more effectively on a statewide basis. For that reason, a third-party administrator was selected for administration of the SBC programs.

For natural gas, expenditures in these program areas are either non-existent or are much lower and focused more on individual LDC needs, rather than on issues of statewide applicability. Thus, the statewide SBC approach does not appear to be appropriate for natural gas. On reflection staff believes that no new funding mechanism for natural gas social program costs is needed at this time as the costs for these programs should continue to be reflected in rates for gas distribution service. The level of such costs can be reviewed as a part of the LDCs’ rate plan.

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[1] Case 94-E-0952 - In the Matter of Competitive Opportunities regarding Electric Service, Issued January 30, 1998.

[2] The SBC excludes programs or activities mandated by state or federal law and those activities undertaken as part of the utility’s ongoing obligation to meet transmission and distribution service requirements.

While broader support for social programs, for example through taxes, has appeal, such action is beyond the purview of this Commission.

Revised Recommendation

No specific funding mechanism for natural gas social program costs is needed at this time as the costs for these programs should continue to be reflected in rates for gas distribution service.

Staff Recommendation (7)

Continue staff monitoring of evolving Federal policies. The Commission should intervene as appropriate to assure that an open, fair, reliable and competitive upstream market exists.

Summary of Comments

Only three commentators address this recommendation. Con Edison and RG&E expressed support for staff's recommendation, with RG&E suggesting that staff confer with the LDCs on issues. Amoco notes that FERC policies will become more important as LDCs leave the merchant function.

Analysis

State unbundling efforts cannot succeed without supportive federal policies. FERC rules and policies will have direct financial impacts including, rates for upstream capacity, the desirability of holding upstream assets, and the attractiveness of pipeline capacity expansions, as well as operational impacts affecting the usefulness and flexibility afforded to capacity acquired by marketers[1].

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[1] That is, when marketers acquire portions of the capacity held by LDCs will they be afforded the same operational flexibility now enjoyed by the LDCs?

These issues will grow in importance during the transition to a competitive market and will require continuous monitoring of Federal policies, collaboration with FERC as appropriate, and active intervention in FERC proceedings. Even if there was no movement to a competitive market, Federal regulation of interstate pipelines would be an area of vital interest to New York. Staff will continue to coordinate with New York’s LDCs, as appropriate.

Revised Recommendation

Continue staff monitoring of evolving Federal policies. The Commission should intervene in FERC proceedings to assure that the state’s interest in an open, fair, reliable and competitive upstream market are voiced.

CONCLUSIONS AND RECOMMENDATIONS

The revised fundamental conclusion and recommendations above are restated below:

(1) The most effective way to establish a competitive market in gas supply is for the LDCs to exit the merchant function. That policy should be implemented taking into account statutory requirements and the needs of each LDC including capacity contract expiration schedules, rate plan (either existing or to be developed), the state of market development, and other relevant factors, with the five year "target" timeframe modified accordingly. The LDC should 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 other interested parties.

(2) LDCs should develop plans to eliminate or restructure capacity contracts as soon as possible.

Capacity assignment is a significant barrier to competition and should not be allowed after April 1, 1999.

The desirability of auctions of remaining capacity contracts should be revisited in the future, especially if FERC changes its rules.

LDCs will be provided a reasonable opportunity to recover strandable costs if they can demonstrate compliance with the Commission directives in Case 93-G-0932 to minimize such costs.

(3) The Commission should resolve POLR issues in collaboration with the electric restructuring proceedings.

(4) No compromise in system reliability will be permitted. LDCs will be allowed to hold assets needed for proper system operations. A collaborative process should be initiated to examine and address future system operation issues[1]

(5) A continuing review of rate design issues is needed to identify changes required to promote a competitive market. Rates should be further unbundled, and other changes considered such as the reform of GACs, the creation of incentives and the elimination of barriers to development of a competitive market.

(6) The Commission should continue to develop safeguards and monitoring mechanisms for market power issues in natural gas markets, building generally on how these issues were addressed in the COB cases.

(7) Staff should continue to monitor LDC customer communications and education programs and identify vehicles which are most effective in enhancing customer awareness and understanding of the competitive market.

LDCs should employ strategies based on market

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[1] Through development of appropriate procedures, protocols, and information systems.

research and, on an experimental basis, design and implement financial and other incentives to create more opportunities for small customer migration.

Natural gas marketer communications efforts are also useful sources of information regarding how best to reach customers. Staff should continue to seek information on these efforts to 1) further its own knowledge of market developments and 2)enhance LDC's and the Department's customer education programs.

(8) A continuing review is needed to assure that regulation becomes more streamlined, flexible, and refocused as the industry evolves.

(9) No specific funding mechanism for natural gas social program costs is needed at this time as the costs for these programs should continue to be reflected in rates for gas distribution service.

(10) Continue staff monitoring of evolving Federal policies. The Commission should intervene in FERC proceedings to assure that the state's interest in an open, fair, reliable and competitive upstream market are voiced.

Together these recommendations will increase competition, enhance customer choice and provide guidance on the future role of LDCs in New York State. These recommendations on specific issues are reformulated and presented below as a vision, goals and implementation plan, to provide an overall framework for the future, and a better sense of what needs to be accomplished by when.

VISION

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 at the citygate;

(2) Overall reductions in customer gas prices;
(3) Increased customer choice of gas suppliers and service options;
(4) A provider of last resort for all residential and firm non-residential customers;
(5) Maintenance of operations procedures that treat all participants fairly and ensure reliable service;
(6) Ample 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;
(8) Coordination of Federal and State policies.

A discussion of each of these goals follows.

First, the most effective way to establish a competitive market in gas supply is for LDCs to exit the merchant function. To move in this direction LDCs should no longer require the assignment of capacity to customers migrating to marketers, and should hold new[1] capacity contracts to an absolute minimum. Where new capacity is needed LDCs should encourage marketers to provide capacity, or if the LDC must acquire capacity, shift to reliance on short-term and citygate arrangements. LDCs should be provided a reasonable opportunity to recover strandable costs if they can demonstrate compliance with the Commission directives in Case 93-G-0932 to minimize such costs.[2] The desirability of auctioning capacity should be revisited in the future, especially if FERC adopts its proposed changes to its capacity release rules.

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[1] By "new" we are referring to both the renewal of expiring contracts as well as entering into contracts for additional capacity.

[2] For example, the costs would be spread over all system sales and firm transportation volumes.

Second, customers who have already migrated to alternative suppliers are enjoying cost savings. Staff's proposal would greatly expand the number of such customers. In addition, we believe an enhanced competitive environment will exert general downward pressure on elements of utility service that can be provided on a competitive basis, and yield synergy savings through the provision of a combination of services through one supplier (e.g., gas, electric, telephone, etc.) that will benefit customers. Costs to some customer groups will likely increase as subsidies are eliminated, but the overall impact is expected to be a reduction in costs.

Third, although LDCs exiting the merchant business will reduce the choice of available gas suppliers, that action must be weighed against the potential harm to the development of competition of allowing regulated LDCs to continue to dominate the supplier function. Staff believes that if the LDC transition out of the merchant business is properly made, the result will be more choice for customers, not less.

Fourth, LDCs should 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 in collaboration with the resolution of HEFPA/POLR in the electric restructuring proceedings.

Fifth, no compromise in system reliability will be permitted. LDCs should be allowed to hold assets needed for system operation. A basic question that will emerge as the portion of upstream capacity controlled by LDCs diminishes and the number of merchants and their share of the market expands is how will the operation of distribution systems change? A better understanding of such changes is needed to address reliability. Related to the issue of operating reliability is the assurance that operating procedures are transparent and treat all participants fairly.

Sixth, enhanced customer education is needed to facilitate the transition to a competitive market. We believe that customers need information on the changes in the industry and marketers offering services, as well as guidance on how to evaluate various offers. We also believe that LDCs must provide customer education as long as they are in the merchant business. In addition, customer inertia needs to be addressed. The use of financial incentives should be considered to facilitate customer interest in alternative suppliers.

Seventh, natural gas market power issues will arise and must be addressed. The Commission has already issued guidelines on horizontal[1] and vertical market power[2] for electric utilities. While similar issues arise for natural gas some of the particular circumstances are different for natural gas and must be carefully monitored and addressed as the transition to a competitive environment proceeds. In addition, a continuing review is needed to assure that regulation becomes more streamlined, flexible, and refocused as the industry evolves.

Eighth, state unbundling efforts cannot succeed without supportive 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. These issues require continuous monitoring of Federal policies, collaboration with FERC as appropriate, and active intervention in FERC proceedings.

IMPLEMENTATION PLAN

There are many steps that must be taken to achieve these goals. In light of the complexity and uncertainties in moving toward a more competitive gas supply market, staff

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[1] As an appendix in the O&R auction order, as well as each subsequent auction order.

[2] Case 96-E-0900, et al, Notice Regarding Vertical market Power, Issued May 20, 1998

believes that to the extent possible, an established timetable would be of benefit and provide guidance to the parties as to how to proceed. We envision an implementation process comprised of two basic elements. The first consists of negotiations with each LDC on its plans to achieve this vision. Implementation should take into account statutory requirements and the needs of each LDC including capacity contract expiration schedules, the state of market development, and other relevant factors, with the five year "target" timeframe modified accordingly.

The second consists of collaboration among staff, LDCs, marketers, pipelines, and other stakeholders on a number of key generic issues and coordination with electric restructuring. These two elements should be pursued in parallel.

Individual LDC Negotiations

(1) Staff recommends negotiations with individual LDCs on a staggered basis rather than simultaneous discussions with all LDCs. We intend to concentrate first on the companies without rate agreements, with expiring rate agreements and companies with earlier expiring capacity contracts.

(2) In planning for such negotiations, each LDC should address the following:

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

(b) A quantification of potential stranded costs and a plan to mitigate and manage them[1].

[1] At a minimum, the LDCs must demonstration that it has made reasonable efforts to minimize strandable costs in compliance with the Commission’s directives in Case 93-G-0932, specifically, the requirements of the Order Clarifying the April 1998 Excess Capacity Filing Requirements, issued September 7, 1997.

(c) A long term rate plan with a goal of reducing or freezing rates (rate design changes will be considered).

(d) A plan to further unbundle rates:

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

   (ii) separately identify distribution cost elements;

   (iii) identify changes which would promote retail competition (e.g., more flexible meter reading arrangements);

(e) A plan to enhance consumer education programs and facilitate customer participation.

(f) The possibility of a more aggressive role for LDCs in facilitating the move to a competitive market (e.g., soliciting customers, bidding out segments of customer base);

(g) Incentives for LDCs to encourage development of a competitive market.

Generic Issues

(1) Staff, LDCs, marketers, interstate pipeline companies and other stakeholders should develop a mechanism to eliminate capacity assignment as soon as possible but no later than April 1, 1999.

(2) Staff, LDCs, marketers, interstate pipeline companies and other stakeholders should examine and address future system operation and reliability issues through development of appropriate procedures, protocols, and information systems, and provide an initial report by April 1, 1999.

(3) Staff, LDCs, marketers, interstate pipeline companies and other stakeholders should examine and develop safeguards and monitoring mechanisms for market power issues in natural gas markets, building generally on

how these issues were addressed in the COB cases, with an initial report due by April 1, 1999.

(4) Resolution of POLR/HEFPA issues, as well as a plan to allow competition in metering, billing, and information services, (MBIS), should be addressed in collaboration with the electric restructuring proceedings.

New York LDC Small Customer Transportation Aggregation (June 1998)

	Residential		Non-Residential		Total	
LDC	**# of Customers**	**Annualized Load (Dth)**	**# of Customers**	**Annualized Load (Dth)**	**# of Customers**	**Annualized Load (Dth)**
BUG	7,512	2,644,388	4,932	6,741,146	12,444	9,385,534
CHGE	0	0	27	221,348	27	221,348
Con Ed	3,646	3,026,126	5,924	7,971,391	9,570	10,997,517
Corning	0	0	0	0	0	0
Lilco	610	116,799	3,540	4,602,729	4,150	4,719,528
NFGD	1,414	167,858	3,158	3,500,630	4,572	3,668,488
NYSEG	81	50,727	620	1,480,466	701	1,531,193
NMPC	358	187,999	2,107	2,745,935	2,465	2,933,934
O&R	918	137,968	578	529,096	1,496	667,064
RG&E	1	80	385	497,243	386	497,323
St.Law	0	0	0	0	0	0
Total	14,540	6,331,945	21,271	28,289,984	35,811	34,621,929