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National Fuel

May 18, 2007

VIA HAND DELIVERY

Hon. Jaclyn Brilling
Secretary
Public Service Commission
Three Empire State Plaza
Albany, New York 12223-1350

Re: Case 07-G-0299 -- In the Matter of Issues Associated with the Future of the Natural Gas Industry and the Role of Local Gas Distribution Companies – Capacity Planning and Reliability

Dear Secretary Brilling:

Enclosed please find an original and ten copies of National Fuel Gas Distribution Corporation's initial comments on the Staff White Paper on Capacity Planning and Reliability pursuant to the March 14, 2007 Notice in Case No. 07-G-0299.

Thank you for your attention to this matter.

Respectfully submitted,

Michael W. Reville /JF

Michael W. Reville, Esq.

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 07-G-0299 – In the Matter of Issues Associated with the Future of the Natural Gas Industry and the Role of Local Gas Distribution Companies – Capacity Planning and Reliability

COMMENTS OF
NATIONAL FUEL GAS DISTRIBUTION CORPORATION
IN RESPONSE TO
STAFF WHITE PAPER

On March 14, 2007, the Public Service Commission ("Commission") issued a Notice of Comment Schedule ("Notice") inviting interested parties to submit comments in response to a white paper ("White Paper") prepared by Department of Public Service Staff ("Staff"). The White Paper "presents a straw proposal intended to ensure the continued reliability of the natural gas system in New York State while preventing the inefficiencies inherent in duplicative capacity assets." The straw proposal posits a model of regulation that would require gas local distribution companies ["LDC"] to adopt mandatory capacity assignment "with some modifications to accommodate marketers who currently bring capacity used to serve core customers." National Fuel Gas Distribution Corporation ("Distribution" or the "Company") is a gas-only LDC serving approximately 720,000 customer accounts in western New York State and Pennsylvania. For its response to the Staff White Paper, Distribution submits the instant comments and answers to five (5) specific questions raised by Staff and set forth in the White Paper (at page 16).

General Remarks

Based on the findings of the Natural Gas Reliability Advisory Group ("NGRAG") Staff has drafted a straw proposal that would recommend the Commission direct LDCs to end the current "voluntary" capacity model in favor of "mandatory capacity assignment." Distribution generally supports a mandatory capacity model as a reasonable means of enabling continuation of retail competition while assuring the future reliability of gas distribution in New York State. Distribution has long advocated mandatory capacity assignment over voluntary arrangements for reasons recognized by the NGRAG and set forth in the White Paper. The Company has argued:

> . . . Distribution does not disagree with a model of competition that relies on the utility, as is currently the case. This would include express acknowledgement of the role of the utility as holder and manager of upstream pipeline and storage capacity. . . . it should be recognized that utilities will not be required to surrender upstream capacity and storage assets to ESCOs on a permanent basis. Rather mandatory capacity release programs should be implemented to assure continued reliability and restore greater certainty to the long-term planning process.[1]

Earlier in the restructuring effort the Commission declined to adopt a mandatory capacity model because it was believed that "capacity assignment is a significant barrier to competition and should not be allowed . . ." Case 97-G-1380, *Report and Recommendations of the Department of Public Service Staff* (issued August 11, 1998) at p. 22. Accordingly, Distribution and other utilities relying on mandatory capacity models at the time were directed to end "capacity assignment" and permit ESCOs to procure capacity on their own, subject to various requirements. See, Case 97-G-1380 *et al.*, Policy Statement Concerning the Future of the Natural Gas Industry in New York State and Order Terminating Capacity Assignment (issued November 3, 1998) ("Policy Statement"). This approach was regarded as both reasonable and prudent for an undefined transition period. Given the recent migration levels Distribution has experienced,[2] however, it has become apparent that the current model cannot be sustained

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1 Case 00-M-0504, *Initial Comments of National Fuel Gas Distribution Corporation in Response to Notice Seeking Comments* (March 2004) at page 8.

2 Since December 2006, customers have migrated to ESCO service at a rate of approximately 3,500 per month, reaching a total of 82,300 as of May 2007. For the same period last year, the rate of migration was approximately 400 per month.

indefinitely. This is because, as Staff observes, "if LDCs shed upstream capacity that has historically served markets in New York State, that capacity would be contracted by marketers or other entities which could choose to serve other natural gas markets, resulting in a loss of upstream capacity serving this state and a concomitant reduction in reliability . . . ." White Paper at 5.

The straw proposal, if adopted, would continue the Commission's approach of advancing retail competition *incrementally*, rather than through sweeping changes and dramatic cutovers favored in other jurisdictions, sometimes to ill effect. Toward that end, while the straw proposal would obviously establish a shift in policy, as a practical matter it merely "locks in" the status quo. Downstate utilities, for example, have been operating under a *de facto* "mandatory capacity" model because the supply of suitable available capacity not held by LDCs is low. See White Paper at 13-14. For Distribution, the straw proposal would require mandatory capacity on a prospective basis but the status quo for marketer-provided capacity would be grandfathered at current levels.

For these reasons, Distribution agrees with the White Paper's findings regarding the need for mandatory capacity, and supports that much of the straw proposal as a well-reasoned and balanced means of enabling further growth in competitive retail markets without jeopardizing the long-term reliability of the state's gas distribution systems. Distribution notes, however, that an order adopting the straw proposal should explicitly recognize that the capacity mix proposed by Staff – mandatory capacity plus grandfathered marketer capacity – satisfies the Commission's requirement for reliable, safe and adequate service. In the absence of such clear guidance, LDCs may be compelled to move toward a mandatory capacity model for all ESCO load.

Responses to Specific Questions

1. *If marketer load being served with capacity not released by the LDC is not "grandfathered," how will the retail access program be affected?*

To begin with, LDCs will be required to contract for pipeline capacity to replace the capacity currently supplied by marketers. Over the short run, the availability of adequate firm, primary point upstream capacity may be an issue for some LDCs depending on market conditions into their service territories. The effect of LDCs re-entering the capacity markets for contracts of presumably greater duration than marketer capacity contracts cannot be ascertained. From Distribution's vantage, however, in the near future there would appear to be no impediments to securing suitable capacity to meet current ESCO-served load.

The marketers are best suited to answer questions regarding the effect of "grandfathering" on their sales. Since marketer-supplied capacity can be less costly than released LDC capacity (due to the lightened minimum annual requirements and lack of need for a ROFR requirement), then presumably retail access activity would slow, assuming such activity depends on the marketers' prices compared to the utility's. On the other hand, if marketers' retail contracts include provisions allowing for price increases arising from regulatory changes, then arguably retail markets can weather the change without disruption. This would certainly be the case for variably-priced contracts, under which price volatility is the norm.

Price increases are routinely caused by any number of factors. While it may be true that a mandatory capacity program might increase prices paid by customers currently served by marketers using their own capacity, the increase would not be without value. In exchange for higher prices, customers would receive service that is more reliable.

While Distribution generally supports Staff's proposal for grandfathering, the Company is concerned about the effect of creating "grandfathered rights" that can be transferred among marketers. If it is assumed that grandfathering has value, then upon implementation of the straw proposal model, marketers holding grandfathered rights will instantly gain a valuable asset that will establish for those marketers a permanent competitive advantage over marketers who do not hold grandfathered rights. Grandfathering, in and of itself, is reasonable, but transferability of grandfathered rights would raise issues that require further analysis, including:

- Can a single marketer acquire enough grandfathered rights to achieve market power (in an unregulated supply market)?
- Will customers experience lower prices, or will marketers merely charge higher margins? Indeed, if grandfathered rights were transferable, then it would be in a marketer's interest to acquire such rights at full value as an alternative to taking release of LDC capacity.

2. *How will local production be affected by this straw proposal?*

So far as Distribution's system is concerned, the straw proposal should not significantly impact local production. Local production delivered directly to Distribution's system averages 15,000 mcf/day of which approximately two-thirds is utilized by marketers to satisfy current small-customer upstream capacity requirements (five-month primary point). The remainder serves industrial and large commercial markets.

Given the historic and expected stability of local production, it is a source of supply that should remain suitable for grandfathering as it is currently utilized.[3] Distribution observes, however, that depending on market conditions, local producers could decide to sell their gas to

[3] On Distribution's system, local production is accepted as a replacement for firm, primary point capacity because it is backed by an allocation of storage capacity. Absent such a reserve contingency, local production would be unsuited for grandfathering.

the industrial and large commercial customers. In addition, some producers could re-route their gas to other systems. In both cases, smaller customers served by local production would have to look to the upstream market for capacity, competing with others for potentially scarce capacity. As such, the availability local production should be monitored regularly to assure its continued availability to small customer markets.

3. *What should happen if a marketer that is grandfathered exits the LDC service territory without selling its entire book to a single entity? For example, should a marketer who takes on some of the existing marketer's book of customers be allowed to bring in its own capacity to serve those customers? Should those customers be considered incremental load and only served by released capacity from the LDC?*

See Distribution's response to question no. 1, above, with respect to the creation of a market for grandfathered capacity rights. Staff proposed to grandfather existing marketer load to minimize the market disruption that would result from a cutover to mandatory capacity. Staff's proposal is also driven by an equitable concern, insofar as marketers who entered into contracts and established business models based on the current capacity model should not be unfairly harmed when the regulatory environment is changed. See White Paper at 8, 15. These concerns rightly focus on the affected marketers, and not the load. The creation of a permanent right based on the current load served by marketer-supplied capacity appears to go well beyond what is necessary to fairly assure reliability and avoid disrupting markets. For these reasons, Distribution believes marketers who take on some of the existing grandfathered marketer's book of customers without obtaining any associated grandfathered capacity should be required to take mandatory capacity for all of the acquired customers.

4. *How is reliability assured in upstate and western parts of the State by grandfathering the marketer's capacity brought to the citygate?*

The Commission previously determined that its requirements that LDCs assure the provision of reliable service were satisfied when marketers supplied their own capacity as a substitute for LDC released capacity. Policy Statement at 5. While it is true that released LDC capacity is *more* reliable than marketer-supplied capacity, the question is whether Staff's proposed capacity model, with a mix of mandatory and marketer-supplied capacity, is sufficiently reliable to assure continued safe and adequate service. Reliability for grandfathered load can be improved if the LDC maintains a capacity reserve sufficient to reflect the risk of losing marketer capacity. See White Paper at 13. Further, because the straw proposal posits a model for capacity management on a prospective basis, the Commission's prior determinations regarding reliability applied to circumstances preceding the straw proposal (or the date of a Commission order adopting the straw proposal) should remain valid. As explained above, an order approving a plan based on the straw proposal should explicitly recognize that the capacity mix proposed by Staff – mandatory capacity plus grandfathered marketer capacity[4] – satisfies the Commission's requirement for reliable, safe and adequate service.

5. *What could be done to improve marketer access/use of storage assets?*

Marketers serving Distribution's customers have direct access and use of storage assets through two mechanisms. Most marketers receive an allocation of Distribution's storage capacity on National Fuel Gas Supply Corporation ("NFGS") through the Federal Energy Regulatory Commission's capacity release mechanism,[5] thereby becoming customers of NFGS. Such storage becomes part of the marketer's gas supply portfolio and so long as system daily delivery requirements are met, may be used to access markets throughout the interstate pipeline

[4] Again, with such grandfathered capacity backed by a reasonable capacity reserve.
[5] Distribution has offered marketers direct access to storage via the capacity releases since 1999.

grid. The quantity of storage provided is adjusted on a monthly basis in response to the load requirements presented by the marketer's customer requirements.

In other cases, marketers procure their own storage capacity directly from NFGS and it is accepted in lieu of the above described intermediate capacity release so long as the capacity is sufficient to meet the load requirements presented by the marketer's customer requirements.

The final element of Staff's straw proposal encourages implementation of Delivery Point Operator/City Gate Swing Service ("DPO/CSC") programs and reliance upon virtual storage programs in the mean time. Distribution believes that relative to its current offering, implementation of a virtual storage program would degrade marketer access to storage capacity. Implementation of a DPO/CSC program, while appropriate elsewhere, would not benefit the marketers, Distribution, or retail customers. Distribution's current program already provides the primary benefit of DPO/CSC, i.e. direct marketer control of storage assets. Other changes necessary to implement DPO/CSC would only add administrative costs for all market participants without sufficient offsetting benefits.

Conclusion

In summary, Distribution generally supports Staff's straw proposal as follows:

- A mandatory capacity model is the best means of assuring capacity retention and long-term reliability;
- Grandfathered marketer-supplied capacity, with an appropriate level of reserve capacity, has proven sufficiently reliable in the past and should be explicitly recognized as sufficiently reliable on a prospective basis;
- Local production, as it is currently utilized, can reasonably be grandfathered without a loss in reliability;

- While grandfathering current marketers' load (regardless of the asset mix) is appropriate, the Commission needs to give further consideration to the market effect of creating a transferable, indefinite property right.

Respectfully submitted,

NATIONAL FUEL GAS DISTRIBUTION CORPORATION

By: Michael W. Reville NF

Michael W. Reville, Esq.
Deputy General Counsel
6363 Main Street
Williamsville, NY 14221
716/857-7313
revillem@natfuel.com

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