BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Investigation Into Competition in the	:	
Natural Gas Supply and Market	:	I-00040103

JOINT REPLY COMMENTS OF
DIRECT ENERGY, DOMINION RETAIL, INC.,
INTERSTATE GAS SUPPLY, SHELL ENERGY,
AND SHIPLEY ENERGY COMPANY

Direct Energy Services LLC, Dominion Retail, Inc., Interstate Gas Supply, Shell Energy and Shipley Energy Company (collectively "NGSs"), hereby jointly offer their responses to the Comments and Testimony provided by various parties in the above-captioned proceeding.

The purpose of the current investigation is to provide the foundation for the report which the Pennsylvania Public Utility Commission ("Commission") must make to the General Assembly regarding the status of competition in the Commonwealth. 66 Pa. C.S. § 2204(g). Upon the Commission's finding that sufficient competition does not exist, it should take all appropriate steps to improve competitiveness. As a threshold matter, the NGSs believe that it is beyond question that sufficient competition does not exist in the gas supply markets in Pennsylvania, and that competition is declining rather than increasing.

Pennsylvania was one of the first states to make the switch to competition in gas markets, at a time when very few competitive models existed. As competition has progressed, however, several hindrances to competition have emerged, with some being more obvious and obstructive than others. The NGSs believe that all parties are best served by working cooperatively in addressing these issues, so that competition is given the best opportunity to flourish. The following comments are intended to respond to the positions taken by other interested parties and to refine what the NGSs believe to be the best solutions.

1. The Price To Compare Has Failed As A Competitive Pricing Benchmark.

The Consumer Advocate makes the point (OCA Comments, pg. 5) that the price to compare is difficult for customers to understand. The NGSs agree. However, the NGSs do not agree with the OCA's conclusion that gas charges that change to reflect market prices are bad for customers. The truth is that even though the SOLR charges that customers see may not change on a monthly basis, customers nonetheless ultimately pay a price based upon the variable charges, and because of the perverse incentives of the 1307(f) mechanism, customers end up paying additional charges for interest on the under-recovered amount. Moreover, the current mechanism masks the actual price of gas so that customers have little to no good information upon which to base consumption decisions, to the extent they wish to do so. The view that customers cannot manage their affairs in a world where prices change in response to market conditions simply is not born out by experience. In the real world, customers act in response to changing market prices every day. At a minimum, customers must begin to see something close to a real price, such as monthly pricing. At present, customers only see an artificial price that changes less often, and where the price of the forecasting error, the 4% interest rate that customers pay to NGDCs on under collections, is hidden from the customers who pay it. The OCA's view perpetuates the myth that is at the heart of the problem with the price to compare, namely, that default service, and the price to compare associated with it, is fixed price service. Simply put, a system that does not provide customers with actual price information disserves those customers and will prevent the development of a competitive market.

The gas cost rate upon which the price to compare is based, is a projection of future gas prices, is reconcilable on a dollar for dollar basis, and most certainly is not a fixed price, but rather, is a variable price. Moreover, because of the perpetual difference between the GCR and the actual experienced gas costs of the NGDCs, the GCR (and hence the price to compare) never represents, in a current period, the actual price that a customer pays for a given volume of gas.[1]

The negative impact of the gas cost rate as a competitive bogey has come completely into focus as gas prices continue to rise and as NGDCs continue to underestimate those increases in setting the gas cost rates. The result for competition is that customers are comparing NGS's competitive offers, which are based upon actual market costs, against GCR rates which in almost every instance underestimate the actual cost of gas. The only way to make a valid comparison is to advance the clock 2 or 3 years, to determine the total amount of natural gas costs that a customer actually paid an NGDC for a particular volume of gas (as well as the associated interest charges). That total price would be substantially different than the price that customers understand they are paying today. Suppliers simply cannot make an offer to customers along the lines of, "I'll only charge you $5.00/mcf today but oh, by the way, next year, I am going to ask you to pay me $2.00 an mcf more, for the same gas, on top of what I charged you this

[1] *See*, Report of the Government Accountability Office "Electricity Markets: Consumers Could Benefit from Demand Programs but Challenges Remain," (August 2004, GAO-04-844) http://www.gao.gov/new.items/d04844.pdf. The report finds that one of the most significant hindrances to demand programs in electric markets is regulated prices that mask market costs from customers.

year, just to make sure I charge you the exact amount."[2] But, that is what NGDCs are required to do. NGSs, by contrast, generally offer fixed and unreconcilable rates for fixed periods.

Section 1307(f) of the Public Utility Code clearly creates an incentive to under-collect as it penalizes NGDCs for over-collecting. In today's volatile market, the chances of an NGDC accurately predicting future gas costs are slim. Hence the GCR rates based upon such predictions are unlikely to hit the mark. Economic prudence demands that the NGDCs err, if at all, by underestimating those gas costs to avoid the 6% over collection penalty.

The price to compare ("PTC") is not a creature of statute, but rather, was created by the Commission to be a competitive benchmark, even though it is based upon the GCR. A statutory change may not *necessarily* be required to fix the problem with the inaccuracy of the PTC, but it appears to be the best way to do so. Simply changing the method of calculating the PTC would be an incomplete solution, at best, because it appears that customers are more likely to look at the price of gas on their gas bill when considering an NGS offer, than to consider the PTC posted on some website. In any event, whatever competitive benchmark is used must accurately reflect changing market prices.

If the Commission does decide to propose a statutory change, such changes could include requiring the NGDCs to adjust the GCR on a monthly basis to reflect actual costs as they are incurred, or, creating a bandwidth around the GCR such that if the NGDC stays within that bandwidth over the reconciliation period, there would be no penalty in

[2] The OSBA has gone so far as to suggest that NGSs simply cannot compete because NGDCs are better at buying gas. Such a position cannot be supported.

the form of interest paid to customers on over collections and no interest collected from the customers for under collection. There may be other solutions that have yet to be proposed. At the end of the day, however, there can be no doubt that neither the PTC, as currently calculated, or the PGC are adequate competitive benchmarks. Neither reflects the true cost of gas for serving a particular customer in the current period, nor provides accurate information to customers. Consequently, customers cannot make informed decisions, which compromises the competitive market.

One other problem that also plagues the price to compare is that it does not represent all of the costs associated with SOLR service, while the suppliers competitive offers necessarily do include such costs. The NGSs recognize the complexity of unbundling these costs, but nonetheless believe that such requirements are essential to improving market competitiveness. Unbundling of the SOLR costs is a necessary part of any approval of an alternate SOLR, which was clearly contemplated by the legislature. 66 Pa. C.S. § 2207.

The NGSs agree that creating a competitive target that more accurately reflects the cost of SOLR service, and therefore, more closely matches a market price for gas, and which includes all of the SOLR related costs of the NGDC, will have a positive impact on the state of competitiveness in Pennsylvania. The time for finger pointing is over, the problem exists and must be fixed.

2. NGSs Should Be Able To Provide Seamless Service To Their Customers

A historic look at the shopping statistics over time makes it clear that enrollment in the competitive market is declining. The Commission could go a long way to helping competitive markets improve and grow simply by allowing NGSs to continue their relationships with customers when those customers move within an NGDC service territory.[3] Because NGSs currently are not permitted to continue serving customers through the move process, and are not permitted to act as the agent for the customer in contacting the NGDC and arranging for the move and arranging for the continuation of NGS service, NGSs lose most, if not all, of their moving customers every year.[4] Such interruptions in service prejudice customers, since they lose the benefit of long term fixed price contracts that they have elected to sign on to, and NGSs lose, because they lose customers and the investment they have made to acquire those customers. Such unnecessary interruptions in NGS service mean that NGSs must increase their customer rolls by an equivalent amount of customers per year, just to tread water and maintain the status quo.

The NGSs should be allowed to provide seamless service to customers, that is, once a customer establishes a relationship with the NGS, the NGS should be capable of maintaining its service to that customer wherever that customer moves within an NGDC service territory. NGSs currently lose customers for no good reason, just because they move, and even if the move is only across the street.

3. Penalties And Imbalance Charges Should Be Market Based

The current system of penalties and imbalance charges is in need of reform. In most NGDC service territories, the penalties associated with imbalances are arbitrary in amount, that is, they do not solely reflect the cost of replacing the gas that was short or disposing of excess gas. In some instances, these penalties can be more than ten times

[3] As Matt Sommer of Shipley Energy testified, approximately 10% of Shipley's customers move every year. Additionally, some NGSs have experiences in other states where customers may be returned to SOLR service simply by altering some aspect of their billing information. Customers should not be returned to SOLR service, under most circumstances, unless they make that choice.

[4] NGSs cannot act on a customer's behalf to initiate new service under any circumstances.

the actual replacement cost. Requiring suppliers to pay as much as ten times the replacement cost for gas for being a few decatherms short on a non-critical day does nothing to improve reliability, since such an under delivery is not likely to be the result of intentional behavior.

The NGSs agree with the Office of Small Business Advocate, that it is appropriate to readjust the penalty structure. In particular, there should be a bandwidth around the delivery requirement for any particular day so that if a supplier delivers within that bandwidth there is no penalty and the supplier simply pays for the gas at the replacement cost of the NGDC. Deliveries outside of that bandwidth would be charged at the market price of gas for that day, which may differ from the NGDCs replacement costs. Being "on the hook" for the market price would create sufficient disincentive for NGSs to divert gas supply, since the "penalty" in the form of a market price would be equivalent to the highest price an NGS could obtain by diverting their gas. The NGSs agree that actual administrative cost should be included as well, and for NGSs that consistently deliver outside of the bandwidth, the Commission may wish to consider an additional adder.

Coupled with this review of imbalance penalties, the Commission should also look at the nomination and delivery rules across NGDCs, with the goal of creating uniformity and fairness. Simply put, NGSs believe that they should not be required to abide by such rules that are more onerous than those applied to the SOLR supplier, whomever it may be. In undertaking its review of these requirements, the Commission should bear in mind that system reliability can be maintained and competition can be improved at the same time; these two goals are not mutually exclusive. Market based penalties can ensure delivery, and fair and flexible nomination rules will not necessarily allow suppliers to harm NGDCs. This Commission has made it clear that it prefers market based solutions in competitive markets and the NGSs ask the Commission to consider such concepts here.

4. NGDC Security Requirements Should Be Transparent And Fair

NGDC security requirements for NGSs serving on their systems are varied by design across the Commonwealth. The NGSs nonetheless believe that those security requirements should be based upon verifiable and readily identifiable criteria and based upon the actual exposure that the NGS causes by reason of its service on the NGDC's system. Moreover, in keeping with the current statutory and regulatory scheme, either the NGS or the NGDC should be able to propose adjustment to the actual exposure based upon the level of risk of the supplier actually defaulting. That is, the Commission's regulations set up what is essentially a two-tiered process. In the first tier, the security should be based upon the actual exposure. In the second tier, the actual exposure can be adjusted based upon that individualized risk or lack of risk factors depending on what the case may be. If an NGS can show the NGDC that the NGS has a significantly lower risk of default, the amount of security can be adjusted downward. Conversely, if the NGDC were able to show that a particular NGS was a higher than average risk for default, the NGS could propose to adjust the security upwards. The Commission would remain the final arbiter of any disputes and should monitor security requirements to ensure fairness and uniformity.

Such a system assumes that any NGSs meeting the same requirements will be required to post the same amount of security per customer. Such a system creates fairness among suppliers and prevents discrimination or any potential anti-competitive behavior. The NGSs agree that arbitrary security requirements can create a barrier to entry into the competitive market place. The Commission also should ensure that each NGDC allows NGSs to post security that meets the NGDC's and NGS's needs, including a full menu of security alternatives. NGDCs should not be permitted to require only a single form of security, or a non-industry standard form. At a minimum, NGDCs should be required to accept industry standard bonds, letters of credit, cash collateral or corporate guarantees (from entities that have investment grade debt ratings).

5. NGDCs Should Be Required To Purchase NGS Receivables.

The NGSs agree that NGDCs that provide billing services should purchase the receivables of the suppliers. NGSs believe that the NGDCs should be made whole for undertaking this obligation. NGDCs that purchase receivables should be permitted the same range of collection options as the agents for the NGS that they enjoy for SOLR service. This would allow NGS customers to be treated in the same way in which NGDC customers are treated. Purchase of NGS receivables is part of the transition to fully unbundling bad debt costs from base rates. Bad debt is one of the most significant costs faced by NGSs that have not been unbundled from those base rates, but which suppliers must include in their pricing. When markets are more mature, NGSs should have the same billing and collection opportunities that NGDCs have today, but until that happens, requiring the purchase of receivables is an essential step in the right direction.

6. The NGSs Have Not Proposed "Ugly" SOLR Service

Both the OCA and the OSBA take issue, at length, with the notion of ugly SOLR service. The NGSs want to make it clear to the Commission that they are not proposing ugly SOLR service. They uniformly agree that the commodity costs that customers pay should be the true cost of the commodity. The NGSs are not proposing to artificially inflate those charges to allow for competition. That is not to say, however, that the NGSs agree that the current ways in which commodity charges are presented to customers are accurate or reflect the true cost of the gas. That is because the PTC is based upon the GCR, which cannot realistically reflect the full cost of gas in the current period, and which does not include all SOLR related costs.

The NGSs do not believe that any artificial price increase is required to move customers to the competitive market. Moreover, while it may not appear that any single suggestion offered herein for improving the competitive marketplace would be singularly sufficient to allow for increased competition, the collective effect of all of these changes--if made--will dramatically increase the ability of marketers to make competitive offers.

Conclusion

NGSs, therefore, request that the Commission reach a determination that: 1) the competitive market place in Pennsylvania is not sufficiently competitive; 2) participation in the competitive market is on the decline; 3) changes are required to improve competitiveness; and, 4) such changes are worthwhile. The NGSs ask that the Commission then consider the following actions, which they believe are necessary to achieving that goal as part of an ongoing process to improve competitiveness statewide:

1. Create a competitive benchmark that reflects the actual cost of gas experienced by the individual NGDCs on a more real- time basis (monthly) as discussed herein;

2. Require NGDCs to purchase receivables;

3. Allow NGSs to provide seamless service to their customers within an NGDC service territory;

4. Examine the imbalance penalty provisions of the various NGDC supplier tariffs and require that all such penalties be market based;

5. Require that security requirements be based upon identifiable and transparent factors and at the threshold reflect the actual risk imposed by any particular supplier on the NGDC, with the ability for either the NGDC or the NGS to adjust upward or downward based upon individualized factors;

6. Consider the unbundling of competitive services currently provided only by the NGDC which could otherwise be provided by competitive market place;

7. Promote uniformity of rules between NGDCs to the greatest extent practical; and,

8. Institute any other changes which tend to improve the competitiveness of the current market place.

Respectfully submitted,

____

Adrian Pye
Direct Energy

____

Vincent Parisi
Interstate Gas Supply

____

Harry J. Kingerski
Shell Energy

____

Thomas J. Butler
Dominion Retail

____

Matthew Sommer
Shipley Energy

Dated: October 12, 2004