

Memorandum 97-30**Public Utility Deregulation: Gas Industry**

This memorandum summarizes the current status of deregulation in the natural gas industry, and the input of stakeholders and the California Public Utilities Commission on the need for code revisions. The material on the current status of deregulation was prepared by Deborah Muns, of Stanford Law School.

CURRENT STATUS OF DEREGULATION

Deregulation of the natural gas industry began in 1978 with the Natural Gas Policy Act. This resulted in federal decontrol of wellhead prices by 1985. The Federal Energy Regulatory Commission then began the process of providing wholesale access to natural gas transmission systems on a non-discriminatory basis, thus providing the opportunity for competition.

Between 1984 and 1993, the California Public Utilities Commission instituted reforms to restructure the natural gas industry at the state level. PUC unbundled, or separated, gas sales from gas transportation services, reformed gas purchase contracts, and opened up access to interstate pipeline transportation capacity to promote gas supply competition. PUC also developed a pricing framework for a new gas transportation and distribution market by unbundling interstate pipeline charges from intrastate transportation rates, establishing intrastate rates, implementing rules for brokering the utilities' interstate pipeline capacity rights, and establishing pricing policy for new facilities. These regulatory steps have allowed a diversity of competing natural gas supply and transportation.

Today, the natural gas industry is moving toward an increasingly competitive market structure. It currently exhibits both competitive and monopoly characteristics.

Consumers may now choose to purchase unbundled gas from non-utility suppliers, with price governed by market forces. For these consumers, the role of PUC is to protect consumers from fraud and misinformation, and to ensure that competitors do not circumvent or distort market forces. Consumers who elect not to participate in competitive gas procurement and transportation markets

(generally residential and small businesses), retain the option of remaining with a regulated provider. Because gas distribution is likely to remain monopolistic, PUC plans to regulate it to protect customers from monopoly abuses. However, rather than basing rates on the cost of service, the PUC is exploring a system that will provide enhanced efficiency incentives to providers.

Although many of the reforms of the natural gas industry are already in place, PUC believes a number of issues remain: maintaining clear standards for regulated utilities that want to participate in unregulated gas procurement and transportation markets; removing alleged market distortions in transportation; ensuring equal, adequate access to market information; and addressing conflicts of interest. In addition, PUC would continue to fulfill its traditional duty to protect consumers from monopoly abuses and ensure "just and reasonable" rates for monopoly services.

INPUT OF STAKEHOLDERS AND PUBLIC UTILITIES COMMISSION

PUC's request for input on code revisions required by deregulation of the gas industry resulted in the letter from Southern California Gas Company, attached as Exhibit pp. 1-7. This letter identifies a number of areas where code revisions may be appropriate.

We have attached a chart as Exhibit pp. 8-16, based on tables provided by PUC, that shows by code section the suggestions of Southern California Gas Company and the preliminary reactions of PUC.

Respectfully submitted,

Nathaniel Sterling
Executive Secretary

Southern California Gas Company... a *Pacific Enterprises Company*James P. Greene
Regional Vice President

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Dear Mr. Kauss:

On behalf of Pacific Enterprises (PE), a diversified energy utility holding company and parent of Southern California Gas Company (The Gas Company), I am pleased to provide you with our suggestions to support the California Public Utilities Commission's (CPUC) review of regulations and statutes as required in Sections 12 and 14 by SB 960.

While the current legislative and regulatory focus is on electric restructuring, it is important to note that each utility industry is going down the path of deregulation, and is at a different point along the spectrum. When reviewing codes and regulations as part of this process, PE strongly urges the CPUC to look at the natural gas industry and its programs in a comprehensive fashion.

The telecommunications companies were the first of the utilities to undergo deregulation, and are the furthest along in the transition. The natural gas industry, which has been undergoing change over the last two decades, is well down the road of deregulation. Now, the electric utilities are beginning to be deregulated. Each of these industries has a unique structure, but the competitive impact of deregulation affects us all. When deregulation does not unfold smoothly, market distortions are created.

The deregulation of the natural gas industry has been a complex undertaking, so I would like to offer a brief look at the history of deregulation efforts in this industry to enable you to better understand our suggested code modifications.

Deregulation of the natural gas industry began with the Natural Gas Policy Act of 1978. Deregulation was initiated because federal regulation of the wellhead price of gas was causing enormous distortions in the price and availability of gas,

including widespread shortages in many sections of the country -- while producing states had a glut of nonregulated gas that could be sold at a lower market cost, but only for intrastate consumption. After a particularly harsh winter in 1976-77, where curtailments were a significant issue, the federal government recognized that their regulatory system was exacerbating the problem and began the process of decontrolling the price of gas.

The federal decontrol of wellhead prices was completed by 1985. Next the Federal Energy Regulatory Commission (FERC) began the process of providing wholesale access to natural gas transmission systems on a non-discriminatory basis, thus providing the opportunity for competition. The CPUC began its work the next year. The changes since that time have been dramatic. For example, the price of natural gas is now set by the market, large customers buy their own gas from producers and brokers, and use The Gas Company only as a transporter. And, interstate pipelines can build additional pipelines with oversight from the federal government, and not the state, and compete directly for the customers of utilities by entirely bypassing The Gas Company's system.

Clearly, the competition stemming from deregulation has forced utilities to operate in a more efficient manner. The Gas Company has lowered its costs and changed its services to adapt to customers' changing needs. To do this, the utility has worked to lower the cost of the gas in its portfolio, and to lower the cost of its operations. The Gas Company also offers new services that our customers value, and remains flexible to meet the needs of the changing market.

Despite these changes in the gas utility operations, there remain significant competitive disadvantages caused by an outdated regulatory structure that imposes costs on utilities that unregulated and new market entrants do not share. If regulation is viewed as a system created to substitute for competition, it follows that when competition appears, regulation should subside, and only ensure that all providers of competitive services are on a level playing field. Many of the anomalies about which PE is concerned stem from "partial" deregulation, where some market participants operate under different rules than the utility does. If the CPUC were to determine that a market is truly competitive, the Commission should remove regulatory oversight for all participants.

Consequently, PE believes that regulation and legislation should balance the utility's freedom to compete in certain markets and its obligation to serve in others. Portions of the utility business are still a monopoly; therefore, regulation is appropriate in those sectors. However, as the gas industry moves further down the road of deregulation, legislation and regulation should emphasize (1) ensuring a


level playing field in the competitive markets, and (2) protecting the customer within the regulated markets.

Finally, it is important in establishing a level playing field that utilities and their affiliates should be afforded no lesser rights or be required to bear any greater regulatory burdens as other companies in the competitive market.

The issues addressed in the attached code revisions are in alignment with the broad policies stated above, and whenever possible provides detailed suggestions to help develop a consistent legislative and regulatory approach that reflects recent deregulation efforts. When modifications to an existing code section are suggested, the section is identified.

PE recognizes that the goal for the CPUC must ultimately be to assure that the result of any change benefits California's energy consumers, and does not simply create a market entrant to benefit at the expense of others. Knowing that it will be your responsibility to balance the economic interest of new market entrants and their customers with the overall benefits of California's energy supply system, PE stands ready to work with you on this important endeavor.

Sincerely,

A handwritten signature, likely of a representative from the Public Employees' Union (PEU), is written in dark ink. The signature is stylized, starting with a large 'J' and ending with a flourish.

Suggested Code Revisions

Non-Bypassable Competitive Transition Charge (CTC):

Existing Law: Statutory law, AB 1890, allows only electric utilities to recover stranded costs. Limited stranded cost recovery has been authorized for natural gas utilities by regulatory decisions.

Why Change is Needed: Gas utilities also have stranded costs that were incurred to respond to the needs of the regulated market.

Proposed Revision: As the gas industry continues to move to retail competition through further unbundling of services, gas utilities should be provided equal treatment and allowed to fully recover stranded costs. PE recommends legislative conformity language to AB 1890 that specifies that prudently incurred stranded costs to gas customers be recovered.

Utility Obligation to Serve:

Existing Law: Current law (Sections 451, 453, 454, 489 and 491) generally recognizes the obligation to serve as a legal duty that requires public utilities to provide "reasonable" service to the public, regardless of a customers' service arrangements or market conditions.

Why Change is Needed: The law should be refined to reflect the competitive energy marketplace and changing customer service options. A utility's obligation to serve should be linked to a customer's obligation to take that service. As the competitive market evolves, customers will have more unbundled service and product options from which to choose. The utility's obligation to provide the service and products, and therefore invest capital, should reflect the character of service and product.

Proposed Revision: Revise the applicable code sections to refine utility obligation to serve to allow flexibility to reflect the competitive implications of the new gas market in which customers have more choice for service providers and different levels of utility service.

Gas Aggregation:

Existing Law: AB 1890 includes provisions that define the ability of market participants to aggregate individual customers and provide retail electric services. The bill also provides customer choice such that no party can aggregate electric customers without their consent. AB 1890 also provides that the serving electric utility is the default provider to any customer that does not agree to be aggregated.

Why Change is Needed: Existing law makes no provisions for aggregation of natural gas customers. Aggregation will be available to gas consumers. (It is already available to some consumers under a PUC pilot program.)

Proposed Revision: The Public Utilities Code should be modified to include the adoption of policy, mirroring what was provided to electric utility customers in AB 1890, affirming a gas utility customers' right to consent to be aggregated, and to identify the utility as the default provider if an aggregator is not identified.

Cogeneration Parity:

Existing Law: Current law (Sections 454, 454.4) requires the CPUC to establish gas transportation rates for cogenerators that are no higher than rates for utility electric generation customers.

Why Change is Needed: The statutory mandate to achieve "parity" is out of place in the emerging market-driven electric generation market. In competitive industries, any artificial pricing destroys the benefits of competition. The policy of parity was adopted to reflect energy policy drivers (conservation and energy efficiency) rather than competition. Parity is economically inefficient. Moreover, the policy results in a cross subsidy that favors cogenerators at the expense of UEGs, sends the wrong price signals to the market, and unnecessarily increases retail electricity prices.

Parity creates market distortions whereby natural gas rates to some cogenerators do not reflect the marginal cost of providing service, and could result in some generators bidding artificially lower priced electricity into the power pool. From a business perspective, parity harms gas corporation shareholders and ratepayers, and could mean throughput losses that lead to increased stranded pipeline capacity costs.

Proposed Revision: The cogeneration parity mandate should be eliminated.

Create Competitive Parity: IOU and Municipal Services:

Existing Law: There is no current law addressing this issue.

Why Change is Needed: A competitive market should require that all participants operate under the same rules.

Proposed Revision: A code provision should be enacted to require that municipal government-owned utilities abide by comparable requirements as investor-owned utilities when the municipal utility provides service outside of its service territory. For example, a code modification should be enacted to require that municipal utilities assume the same tax burdens as investor owned utilities when operating outside of their service territory.

Disposition of Utility Property:

Existing Law: Current law (Public Utilities Code Section 851) requires CPUC approval for the transfer (sale or other disposition) of all necessary or useful public utility property.

Why Change is Needed: Current law does not distinguish between property used in providing utility services from property serving the competitive market. Minimal regulatory review is necessary for conveyances of property not used for core utility purposes.

Proposed Revision: Section 851 should be limited to restrict the CPUC's authority to regulate only the disposition of utility property that is exclusively necessary and useful in the provision of utility service. The utility should be given the flexibility to transfer, without prior CPUC authorization, utility property not used exclusively in the provision of utility service in the regulated sector.

Rate Structure:

Existing Law: Current law (Sections 739 and 739.1) for residential rates and low-income customer programs (CARE) creates imbalances in how costs are allocated within and between customer classes.

Why Change is Needed: The inverted rate structure (baseline) and the provision that the costs of the CARE program shall not be borne solely by any single class of customer impose cost allocation discrepancies.

Baseline was established to help implement the public policy principle of energy conservation. Yet, in a competitive market, baseline creates competitive issues that result in inequities in ratemaking because it rewards low consumption and penalizes high consumption without regard to the customers' circumstances. A "yuppie" couple with no children in a new, energy efficient home is rewarded. A large family with some members home during the day in an older, less-efficient home are punished.

CARE was created to provide low income utility customers with affordable energy, and requires utilities to levy the cost of the CARE program on all customer classes. Because businesses cannot receive the benefits of the CARE program, it is inconsistent with a competitive market that they be responsible for these costs, particularly on a volumetric basis. In light of the competitive market that natural gas utilities face, it no longer makes sense for the costs of the program to be borne by significantly a class of customers that cannot benefit from it.

Proposed Revision: The law should be clarified to provide that the drivers in the competitive market are cost causation, economic efficiency and competitive forces, balanced with the policies of affordability and conservation. The statutory provisions governing baseline and CARE should be so modified so as to minimize rate making inequities.

Natural Gas				
Code Section	Suggested Action	Rationale	Opposition	CPUC
451, 453, 454 451 Requires public utilities to charge just and reasonable rates for services. 453 Prohibits public utilities from providing preferential rates or services to any customer. 454 Prohibits public utilities from changing rates, except upon showing to Commission that the new rate is justified.	Amend: SoCal Gas suggests amending these sections to refine utility obligation to serve to allow flexibility to reflect the competitive implications of the new gas market in which customers have more choice for service providers and different levels of utility service.	These sections generally recognize the obligation to serve as a legal duty that requires public utilities to provide "reasonable" service to the public, regardless of a customers' service arrangements. The law should be refined to reflect the competitive energy marketplace and changing customer service options. A utility's obligation to serve should be linked to a customer's obligation to take that service. As the competitive market evolves, utility's obligation to provide the service and products, <u>and therefore invest capital</u> , should reflect the character of service and product.		Agrees in concept--however, major revision is premature at this time given the fact that competition at the retail level has just commenced. Also, there is need to maintain notice and procedure requirements for remaining public utilities because competition has not developed sufficiently.

<p>489 Requires the Commission to order public utilities to file schedules containing rates, charges, classifications, rules, etc.</p>	<p>Amend: SoCal Gas suggests amending these sections to refine utility obligation to serve to allow flexibility to reflect the competitive implications of the new gas market in which customers have more choice for service providers and different levels of utility service.</p>	<p>The law should be refined to reflect the competitive energy marketplace and changing customer service options. A utility's obligation to serve should be linked to a customer's obligation to take that service. As the competitive market evolves, utility's obligation to provide the service and products, <u>and therefore invest capital</u>, should reflect the character of service and product.</p>		<p>Unclear since precise change is not provided--any amendment should preserve requirements for traditional public utilities. CPUC will work SoCalGas on language.</p>
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<p>491 Requires 30 days notice for rate, rule, and classification changes unless the Commission approves less.</p>	<p>Amend: SoCal Gas suggests amending these sections to refine utility obligation to serve to allow flexibility to reflect the competitive implications of the new gas market in which customers have more choice for service providers and different levels of utility service.</p>	<p>The law should be refined to reflect the competitive energy marketplace and changing customer service options. A utility's obligation to serve should be linked to a customer's obligation to take that service. As the competitive market evolves, utility's obligation to provide the service and products, <u>and therefore invest capital</u>, should reflect the character of service and product.</p>		<p>Unclear since precise change is not provided-- however, CPUC disagrees in that current section permits exception to the 30 day notice requirement, but does agree that competitive markets should be less restrictive.</p>
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<p>454.4 Requires Commission to set rates for gas used in cogeneration technology projects no higher than rates for gas used as fuel by an electric plant.</p>	<p>Delete: SoCalGas suggests eliminating the parity mandate.</p>	<p>The statutory mandate to achieve "parity" is out of place in the emerging market-driven electric generation market. In competitive industries, any artificial pricing destroys the benefits of competition. Moreover, the policy results in a cross subsidy that favors cogenerators at the expense of UEGs, sends the wrong price signals to the market, and unnecessarily increases retail electricity prices.</p> <p>Parity creates market distortions whereby natural gas rates to some cogenerators do not reflect the marginal cost of providing service, and could result in some generators bidding artificially lower priced electricity into the power pool.</p>		<p>Agrees in concept-- mandatory cogeneration rate parity with UEF rates is inconsistent with a competitive energy market. CPUC will work with supporters of proponent on language.</p>
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<p>739 Requires the Commission to designate a baseline quantity of gas and electricity which is necessary to supply a significant portion of the reasonable energy needs of the average residential customer; requires electrical and gas corporations to file a schedule of rates and charges providing baseline rates.</p>	<p>Amend: SoCalGas suggests that the statutory provisions governing baseline should be modified so as to minimize rate making inequities. Also suggests that the law be clarified to provide that the drivers in the competitive market are cost causation, economic efficiency and competitive forces, balanced with the policies of affordability and conservation.</p>	<p>The inverted rate structure (baseline) creates imbalances in how costs are allocated within and between customer classes. Baseline was established to help implement the public policy principle of energy conservation. Yet, in a competitive market, baseline creates competitive issues that result in inequities in ratemaking because it rewards low consumption and penalized high consumption without regard to the customers' circumstances. A "yuppie" couple with no children and a new, energy efficient home is rewarded; a large family with some members home during the day in an older, less-efficient home is punished.</p>		<p>Agrees that the system of baseline rates and allowances needs to be reviewed in light of deregulation, but disagrees with a total repeal at this time.</p>
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<p>739.1 Requires the Commission to establish an assistance program for low-income electric and gas customers, the cost of which shall not be borne solely by any single class of customer. (The CARE program).</p>	<p>Amend: SoCalGas suggests that the statutory provisions governing CARE should be modified so as to minimize rate making inequities. Also suggests that the law be clarified to provide that the drivers in the competitive market are cost causation, economic efficiency and competitive forces, balanced with the policies of affordability and conservation.</p>	<p>The provision that the costs of the CARE program shall not be borne solely by any single class of customer imposes allocation discrepancies. CARE was created to provide low income utility customers with affordable energy, and requires utilities to levy the cost of the CARE program on <u>all</u> customer classes. Because businesses cannot receive the benefits of the CARE program, it is inconsistent with a competitive market that they be responsible for these costs.</p>		<p>Agrees that the system of baseline rates and allowances needs to be reviewed in light of deregulation, but disagrees with a total repeal at this time.</p>
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<p>851 Requires Commission approval for the transfer, sale, merger, or other disposition of all necessary or useful public utility property.</p>	<p>Amend: SoCalGas suggests modifying to restrict the Commission's authority to regulate only the disposition of utility property that is exclusively necessary and useful in the provision of the utility service. Suggests that the utility should be given flexibility to transfer, without prior Commission authorization, utility property not used exclusively in the provision of utility service in the regulated sector.</p>	<p>Current law does not distinguish between property used in providing utility services from property serving the competitive market. Minimal regulatory review is necessary for conveyances of property not used for core utility purposes.</p>		<p>Opposes amendment--ratepayer interests must be protected.</p>
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Proposed new section dealing with competitive parity.	Add: SoCalGas suggests enacting a new section to require that municipal government-owned utilities abide by comparable requirements as investor-owned utilities when the municipal utility provides service outside of its service territory.	A competitive market should require that all participants operate under the same rules. For example, a code modification should be enacted to require that municipal utilities assume the same tax burdens as investor owned utilities when operating outside of their service territory.		Did not address
Proposed new section dealing with stranded cost recovery. (Non-Bypassable Competitive Transition Charge (CTC)).	Add: SoCalGas suggests enacting a new section that specifies that prudently incurred stranded costs to gas customers be recovered- -similar to Sections 367-368 (added by AB 1890, 1996 Cal. Stat. Ch. 854).	Current statutory law allows only electric utilities to recover stranded costs. Gas utilities also have stranded costs that were incurred to respond to the needs of the regulated market. (Limited stranded cost recovery has been authorized for natural gas utilities by regulatory decisions.)		Did not address.

<p>Proposed new section regarding gas aggregation.</p>	<p>Add: SoCalGas suggests enacting a new section that affirms a gas utility customers' right to consent to be aggregated, and to identify the utility as the default provider if an aggregator is not identified. Such a provision would mirror what was provided to electric utility customers in Section 366 (added by AB 1980).</p>	<p>Existing law defines the ability of market participants to aggregate individual customers and provide retail electric services. It also provides customer choice such that no party can aggregate electric customers without their consent, and that the serving electric utility is the default provider to any customer that does not agree to be aggregated.</p> <p>But existing law makes no provisions for aggregation of natural gas customer, and aggregation will be available to gas consumers. (It is already available to some consumers under a PUC pilot program.)</p>		<p>Did not address.</p>
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