

Natural Gas Price Issues in Ohio

- **Causes of Recent Price Increases**
- **Impact of Increases on Customer Bills**
- **Impact of Increases on Natural Gas Choice Programs**

A Report by the Staff of the Public Utilities Commission of Ohio
May 15, 2001

Public Utilities Commission of Ohio
180 East Broad Street
Columbus, Ohio 43215



News Release

The Public Utilities Commission of Ohio • 180 East Broad Street • Columbus, Ohio 43215-3973

FOR IMMEDIATE RELEASE

May 22, 2001
01-039

CONTACT: Shana Gerber, Media Office
614-466-7750 / 614-752-8802(f)
<http://www.puc.state.oh.us>

PUCO Staff Reports Typographical Error in Natural Gas Price Study

COLUMBUS, OH – The Staff of the Public Utilities Commission of Ohio (PUCO) yesterday reported that its report, entitled Natural Gas Price Issues in Ohio, contains a typographical error. PUCO Staff issued the report on May 15, 2001.

On page 17 of the report, Staff twice refers to Summit Energy as one of the competitive suppliers that was terminated from one of the Ohio natural gas choice programs this past winter. The report should reflect that Summit Natural Gas and Power Solutions, Inc. was terminated in December 2000 from one of the natural gas choice programs. The data regarding Summit Natural Gas and Power Solutions contained in the report is correct, but it is mistakenly named as Summit Energy.

Summit Energy (Summit Energy Services, Inc.), a Louisville, Kentucky-based energy management firm, is not related to Summit Natural Gas and Power Solutions, Inc. Summit Energy is not a competitive supplier involved in marketing natural gas to end-users in Ohio or anywhere else in the United States.

The PUCO Staff regrets and apologizes for any confusion this may have caused.

**-30-
01-152-GA-UNC**



This report is available electronically on the PUCO's Internet site.

www.puc.state.oh.us

Table of Contents

Executive Summary	i
Introduction	1
Natural Gas Price Issues	2
A. What Were the Causes of the Recent Gas Price Increases?	2
1. Supply Conditions in the Nation and Ohio	2
2. Demand Conditions in the Nation and Ohio	4
B. What Was the Impact of the Gas Price Increases on Customers' Bills?	6
1. The Base Rate	7
2. The Gas Cost Recovery Rate	7
3. Effect of the Gas Price Increases on the Gas Cost Recovery Rates	9
4. The Competitive Suppliers' Rates	9
5. Effect of the Gas Price Increases on the Competitive Suppliers' Rates	10
C. What was the Impact of the Gas Price Increases on Ohio's Natural Gas Choice Programs?	10
1. Ability to Compare and Compete with the Gas Cost Recovery Rates	11
2. Enrollment Issues	14
3. Competitive Supplier/Customer Contract Issues	15
4. Complaint Handling	18
D. Potential Remedies	19
1. Remedies for the Gas Price Increases	19
2. Remedies for Ohio's Natural Gas Choice Programs	20
Conclusion	25
Appendix	26



Executive Summary

The recent rise in natural gas prices in Ohio is a reflection of the market forces that have disrupted the flow of energy nationwide. An increased demand for natural gas occurred during the 2000-2001 winter months as a result of the convergence of several critical factors. The dramatic increase in demand exceeded the ability of the supply side of the market to react expeditiously, and in response to this unbalanced state, the price of natural gas increased to the much higher market-clearing price. Unfortunately, this adjustment was partially caused by – and occurred during – a winter heating season that was much colder than normal in Ohio and elsewhere.

The national supply of natural gas had been growing tighter as the number of producing wells and amount of production had declined in response to low price signals for natural gas in 1998-1999. Additionally, national gas storage levels going into the winter of 2000-2001 were also lower than normal because natural gas companies were reluctant to purchase, for storage, gas which appeared to be high-priced. Moreover, the growth in demand for natural gas has been heavily influenced on a broader national level by the increased use of this commodity as a fuel for generating electricity. Also, demand from commercial and industrial sectors has been strong due to a prolonged period of growth in the U.S. economy. Thus, the supply of natural gas on hand was generally more restricted than in the past.

The sharp increase in the price of natural gas in Ohio in the winter of 2000-2001 was not unique to the state; the entire country also experienced the natural gas price increase. As the 2000-2001 winter began, the temperatures were colder than average in many parts of the country, including Ohio. Customers increased their demands beyond anticipated levels. The local distribution companies and competitive suppliers in Ohio that purchased gas going into the heating season and during the heating season made purchases of natural gas at higher wholesale commodity prices compared to prior years. Those higher wholesale costs were often passed onto customers. High commodity prices, combined with increased usage for heating purposes, caused consumer gas bills to increase dramatically.

The sharp increase in natural gas prices in Ohio during the 2000-2001 winter period also impacted the behavior of the competitive suppliers and customers participating in Ohio's gas choice programs. Price changes made both competitive suppliers and consumers more sensitive to issues such as the timing of the actual change from the local distribution company's to the competitor's supplies, the viability of certain contract pricing mechanisms, and the risks associated with variable and fixed rate contracts. The rapid change in gas prices also revealed the difficulty that some of the competitive suppliers have to cope with, and compete fairly in, a volatile commodity market. The price changes put pressure on the competitive suppliers' margins (their ability to make a profit). As a result of the sharp price increases, some competitive suppliers broke their contracts with their customers by leaving the gas choice programs, by being terminated from the programs because of failure to supply gas, or by unilaterally changing the terms of their customer contracts. These actions led many gas choice customers to lose the benefit of their bargain or become disillusioned by the gas choice programs.

Currently, higher natural gas prices have triggered an increase in drilling activity nationwide, including in Ohio. This increased production should ease upward price pressures as additional gas supplies reach the market. Moreover, consumer sensitivity to high gas bills may impact demand levels in the future. It remains unknown, however, whether the demand levels caused by any economic growth and the needs of new electric generating plants will either taper off or stabilize such that the recent supply/demand imbalance will not resurface again during periods of extreme temperatures (the summer months and winter months). However, this past winter heating season has highlighted the need for suppliers (local distribution companies and competitive suppliers) to improve supply forecasting and price risk management. Competitive suppliers, in particular, will need to focus on the fundamentals of adequate capitalization, risk management, and back-office operations. In the longer term, this period of instability may have some beneficial effects. It has brought to the fore issues of reliability of competitive suppliers and competitive supplier behavior, as well as customer and supplier response to price change.

While much of the turmoil of the gas prices was taking place and in response to public concerns, Ohio's Legislature debated and concluded that certain additional standards are appropriate for competitive suppliers to continue to operate in Ohio. The new law, Amended Substitute House Bill 9, also enables aggregation of customers by governmental entities. As a result of the experiences gained and the new legislation, Ohio has the opportunity to shape a more effective competitive market for future heating seasons.



Introduction

On March 1, 2001, the Public Utilities Commission of Ohio (Commission) directed its Staff to prepare a report that would address the recent increase in natural gas prices and the impact of those prices upon Ohio consumers and the choice programs. This report responds to the Commission's directive.

In this report, the Staff initially reviews the natural gas supply and demand situation that developed in the U.S. and in Ohio. The impact that last winter's increased prices had on the Ohio natural gas industry and Ohio consumers was the result of longer term supply and demand trends. The Commission has expressed its concerns over the sharp increases in natural gas prices and their consequence. The Commission and its Staff have also worked to address those issues that fall within the Commission's jurisdiction.

Next, the Staff assesses the impact of the events upon Ohio's local distribution companies (LDCs), competitive suppliers, three natural gas choice programs and consumers. This past heating season, consumers were charged some of the highest natural gas commodity prices in Ohio history. In the second part of this report, the Staff explains how those wholesale commodity costs are passed onto LDC customers. This portion of the report and the next also detail the benefits of the pass-through mechanism, as well as its distortions in times of compounding price changes. Additionally, the high commodity costs were reflected in competitive suppliers' rates and illustrated in the second part of this report as well.

Approximately 650,000 residential and 55,000 commercial customers are currently participating in Ohio's three gas choice programs. The majority of these consumers has had positive experiences with the programs and has enjoyed the benefits of lower prices. The third part of this report describes the effects that the market events described in the first part of this report have had on some gas choice customers. Specifically, we detail the difficulties in comparing LDC and competitive supplier prices, and how some of the weaknesses of the enrollment processes were magnified during the last winter heating season. Additionally, we report on some impacts to the competitive marketplace and market abuses, which we believe either stemmed from the rapid increase in wholesale commodity prices or were exacerbated by the price increases.

In the last part of this report, the Staff sets forth possible remedies to avoid future reoccurrences of the negative circumstances that recently resulted from the price increases.



Natural Gas Price Issues

A. What Were the Causes of the Recent Gas Price Increases?

The recent rise in natural gas prices in Ohio is a reflection of the market forces that have disrupted the flow of energy nationwide. The disparity between supply and demand was not unique to Ohio. The rest of the country also experienced the imbalance situation and resulting wholesale and retail price increases.

1. Supply Conditions in the Nation and Ohio

Analyzing the supply of natural gas begins with reviewing the data related to drilling rigs. When prices of natural gas are low or decreasing, the economic incentive to expand drilling declines. Conversely, when natural gas prices are high or increasing, the economic incentive to expand drilling increases. Drilling for new wells had fallen over the last couple of years as natural gas prices had decreased to the point where it was not economically justified for companies to develop new natural gas sources. In 1998 and 1999, consumers were blessed with lower natural gas prices relative to 1997. Correspondingly, the rigs drilling for natural gas had declined from a recent North American peak of 1,499 in December of 1997 to a low of 558 in April of 1999.

With the decline in drilling rigs in operation, the natural gas industry's production growth decreased from 1997 to 1999 (i.e., 18.9, 18.7 and 18.6 trillion cubic feet). However, in 2000, the production growth increased to 19.3 trillion cubic feet. This may have been the result of increased prices. The average price charged by producers in 1998 and 1999 to find and produce natural gas in the U.S. (the wellhead price) also dropped below the 1997 price. From 1995 to 2000, the U.S. average natural gas wellhead prices were as follows:

Table 1: Average Natural Gas Wellhead Price, 1995-2000

<u>Year</u>	<u>Average Wellhead Gas Price per Mcf</u> ¹	<u>Percent Change from Prior Year</u>
1995	\$1.55	-
1996	\$2.17	+ 40.0%
1997	\$2.32	+ 6.9%
1998	\$1.94	- 16.4%
1999	\$2.17	+ 11.9%
2000	\$3.60	+ 65.9%

Although the average wellhead price for natural gas in 2000 was \$3.60 per Mcf, the price escalated rapidly through the year when wellhead prices went from \$2.12 in

¹ Gas amounts can be measured in cubic feet. In this report, one hundred cubic feet is designated as "Ccf", one thousand cubic feet is designated as "Mcf", one million cubic feet is "MMcf, and one billion cubic feet is "Bcf".

January 2000, to \$3.70 in July 2000 (a 75 percent increase in six months), then to \$6.35 in December 2000 (a 200 percent increase in 12 months).

During this same timeframe, the national demand for natural gas was rising with the surging U.S. economy. The U.S. natural gas industry, as a whole, was not meeting the increasing demand for its product. This mismatch of supply and demand began to be reflected in prices as the 1999-2000 heating season came to a close and the 2000 summer storage injection season was about to begin.

Ohio's supply of natural gas is a mix of about 13 percent Ohio-produced and 87 percent brought in via the interstate pipeline system. Thus, one cannot look only to the national natural gas supply situation for an understanding of the natural gas supplies in Ohio. However, like the national situation, the amount of Ohio-produced gas has been declining on an annual basis from 1995 to 2000 (from 120,444 MMcf in 1995 to 98,551 MMcf in 2000). The number of operating Ohio gas wells also declined from 34,483 in 1995 to 33,897 in 2000. The average price per Mcf for Ohio-produced natural gas from 1996 to 2000 was \$2.63, \$2.74, \$2.24, \$2.41 and \$4.06, respectively. The changes in Ohio-produced gas prices over these years are generally consistent with the average national wellhead prices depicted in Table 1 above for the same years.

Many recent popular and technical literary sources have attributed much of the last year's natural gas price rise to a dramatic increase in the usage of natural gas by the electric industry to generate electricity at peak times. This contributed to keeping the natural gas market price higher than normal during this past summer, but does not fully explain the subsequent increase in natural gas prices for the second half of 2000, particularly for Ohio.

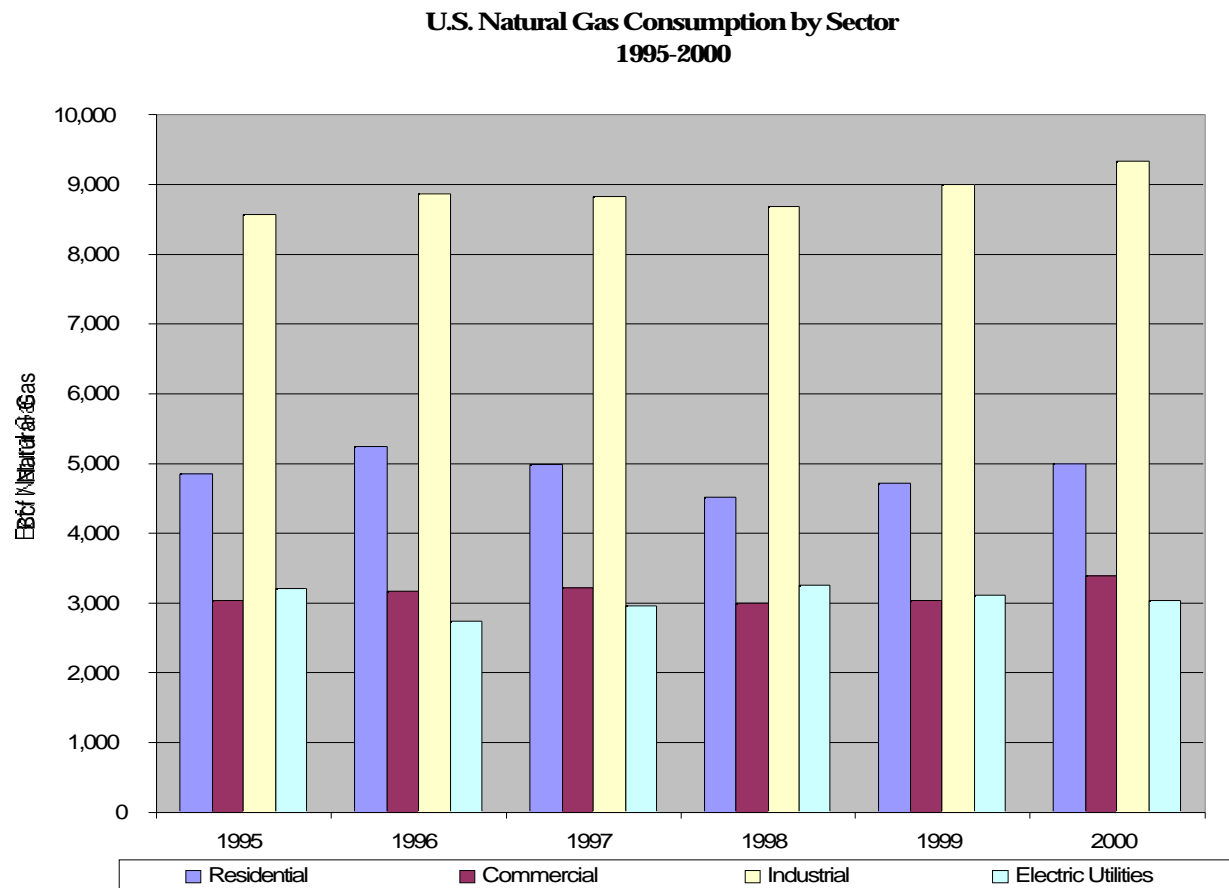
The changing prices for natural gas across the country in the first half of 2000 and the use of natural gas by the electric industry in parts of the country during the summer of 2000 disrupted the usual practice of natural gas companies to refill their storage facilities in preparation for the 2000 heating season. Natural gas in storage provides, on a national average, about 20 percent of the winter heating season's natural gas demand. Because prices for natural gas were historically high last summer, natural gas companies across the nation were slow to buy and inject gas into storage, hoping to capture more reasonably priced gas before the limited refill season came to a close. Lower, more reasonably priced wholesale gas was not widely available for injection into storage by the time the 2000-2001 winter heating season began. Nationally, the natural gas industry entered the 2000-2001 heating season with lower than usual storage levels to draw from over the 2000-2001 winter. This conservative approach to storage, combined with harsher winter weather, exacerbated the rise in gas prices over the course of the winter.

Ohio's LDCs that utilize storage facilities reported to the Staff that they were generally on target for their storage levels as the winter heating season began last year. Even if the Ohio LDCs that utilize storage capacity were on target based upon their estimates of gas usage, Ohio LDCs purchased additional amounts of gas during the heating season to fulfill the actual consumer usage. Therefore, the low storage levels of other natural gas companies across the country did impact the available supplies.

2. Demand Conditions in the Nation and Ohio

The prolonged period of growth of the U.S. economy has increased demand for natural gas nationally and in Ohio. Natural gas demand has increased every year since 1986 with the commercial and industrial sectors seeing the greatest demand increase.

The following illustrates the national growth in natural gas consumption between 1995 and 2000:



As noted earlier, an increase in the development of new electric generating plants is occurring across the country. This growth is in response to restructuring efforts in the electric industry and also in response to the growing demand for electricity. Many of the new electric generating plants utilize natural gas as a fuel source. This development has contributed to increasing the demand for natural gas supplies across the country. Although the construction of new, gas-fired generation facilities in the Ohio has not yet caused an increased demand for natural gas, this type of development in other states has nevertheless impacted the ability to obtain natural gas for Ohio consumers.

In recent years, many utilities across the country and in Ohio have divested a portion of their generation assets and newer generation is commonly owned by

nonregulated corporate entities. The natural gas consumed by nonregulated corporate entities is not captured in the data in the above graph for the electric utility industry but, instead, is included in the industrial sector data. The following table shows natural gas consumption for electric utilities and the nonutility power producers:

Table 2: Natural Gas Used to Produce Electricity, 1995-2000
(in trillion cubic feet)

<u>Year</u>	<u>Electric Companies</u>	<u>Nonutility Power Producers</u>	<u>Total</u>
1995	3.20	2.30	5.50
1996	2.73	2.45	5.18
1997	2.97	2.23	5.20
1998	3.26	2.67	5.93
1999	3.11	2.66	5.77
2000	2.85	3.23	6.08

The increase in the cost of crude oil also impacted the demand for natural gas on a national level, particularly for large commercial and industrial customers. Higher crude oil prices can contribute to increasing the demand for natural gas as customers switch energy sources. This, in turn, puts upward pressure on natural gas prices. Over the last several years, the prices of natural gas at the wellhead and of crude oil have exhibited similar trends. The very sharp increase in fuel oil costs in 2000 further spurred demand for natural gas and contributed to the increase in price for that commodity:

Table 3: Comparison of Changes in National Average Wellhead Gas Prices and Average Crude Oil Composite Prices, 1995-2000

<u>Year</u>	<u>Average Wellhead Gas Price (per Mcf)</u>	<u>Percent Change from Prior Year</u>	<u>Average Crude Oil Composite Price</u>	<u>Percent Change from Prior Year</u>
1995	\$1.55	-	\$17.23	-
1996	\$2.17	+ 40.0%	\$20.71	+ 20.2%
1997	\$2.32	+ 6.9%	\$19.04	- 8.1%
1998	\$1.94	- 16.4%	\$12.52	- 34.2%
1999	\$2.17	+ 11.9%	\$17.51	+ 40.0%
2000	\$3.60	+ 65.9%	\$28.23	+ 61.2%

Ohio's demand for natural gas has remained relatively steady between 1995 and 1999, with total consumption (in MMcf) of 896,072 in 1995, 936,430 in 1996, 878,124 in 1997, 813,022 in 1998, and 846,741 in 1999. However, on an annual basis, the demand for natural gas in Ohio peaks during the winter heating season. This is because natural gas is consumed in greater quantities during the winter for heating purposes. Because Ohio is a strong market for using natural gas as a heating fuel, weather can have a significant effect on Ohio's demand data. The 2000-2001 winter heating season was no

different. Weather had a significant impact on the usage of natural gas. Ohio's actual weather during the 2000-2001 heating season was unusual because the winter started out significantly colder than normal and the winter, overall, was colder than the past two mild winters. In addition, early storage withdrawal caused by the heavy demand helped increase the momentum of the upward price trend.

Columbia Gas of Ohio Inc. (Columbia) provides gas service to customers in 64 of Ohio's 88 counties, from the northern part of the state to the southern part. Columbia calculated the average number of calendar month heating degree days for its service territory. The calculation of degree days for heating is a measure of the cold weather experienced based on the extent to which the daily mean temperature falls below a referenced temperature (e.g., 65 degrees Fahrenheit). For example, on a day when the mean outdoor temperature is 35 degrees F, 30 degree days would be experienced. A daily mean temperature usually represents the sum of the high and low temperature reading divided by 2. Colder weather results in more heating degree days and more gas being consumed to heat homes. The following is Columbia's calculation for this past heating season:

Table 4: Calculation of Heating Degree Days for the Columbia Service Territory, November 2000-March 2001

<u>Month</u>	<u>Actual</u>	<u>Normal</u>	<u>Percent Difference</u>
November	645	594	+ 8.6
December	1,243	967	+ 28.5
January	1,037	1,139	- 9.0
February	795	948	- 16.1
March	789	711	+ 11.0
Total	4,509	4,359	+ 3.4

Columbia's data verifies that the winter weather in Ohio started out colder than normal. The colder temperatures increased early-winter customer usage of natural gas for heating purposes. In addition to the increased usage over normal cold temperatures, customers had experienced warmer than normal temperatures the past two winters. Therefore, usage for heating purposes was up significantly over the prior two years.

Based upon the foregoing, there was a tight natural gas supply and strong demand for gas that created an imbalance going into last year's heating season. Natural gas prices continued to rise in response to further demands for the commodity when suppliers sought additional quantities. The early winter weather in Ohio caused even greater demands for gas supplies.

B. What Was the Impact of the Gas Price Increases on Customers' Bills?

For customers purchasing gas from most Ohio LDCs, the bill for natural gas service consists primarily of two rates, the base rate and the commodity charge for the gas. (There are a small number of Ohio LDCs which serve their customers pursuant to

contract rates and which do not have a separate commodity charge.) For customers purchasing gas from competitive suppliers, the bill consists primarily of the LDC's base rate and the price at which the competitive supplier sells gas to its customers. A summary of the rates follows.

1. The Base Rate

The base rate is that part of the customer's bill that compensates the LDC for its operating costs in distributing gas to end-use customers, plus a reasonable rate of return on its property. The base rate is also the portion of the LDCs' operations that is still subject to traditional state regulation. The Commission determines base rates during a rate proceeding. The base rates for the major Ohio LDCs have not been changed in several years.

2. The Gas Cost Recovery Rate

The gas cost recovery (GCR) mechanism was developed in Ohio in the 1970s to segregate the LDCs' recovery of gas commodity costs (which can vary greatly over time) from the delivery costs (which are relatively stable). The mechanism is designed so that the LDCs are able to recover their actual, prudently incurred, commodity costs in full. The LDCs are prohibited from making a profit on these costs. The GCR mechanism also provides for deferrals and recovery through periodic adjustments. This allows the GCR to serve both as a mechanism for assuring fair and appropriate commodity cost recovery for the LDCs, and for reducing the impact of quick or unpredictable changes in commodity prices on the end-use customers. The GCR continues to serve these functions for those consumers who choose to keep their LDC as their gas supplier. The recent price increases in the wholesale commodity rates for natural gas caused the GCR rates to increase, which in turn caused increased consumer bills.

Ohio LDCs calculate their GCR rates every three months, although they may request midcycle adjustments if circumstances warrant. The GCR rate is made up of a number of components. To simplify the discussion, we will look at these components in two groups: estimated gas costs (EGC) and adjustments. The EGC comes the closest to being a "price for natural gas", in that it is an estimate of the wholesale gas price that the LDC expects to pay during the three-month period in which that GCR rate will be in effect. Of course, being an estimate, the chance of it being perfectly accurate over a three-month period is remote. This necessitates various adjustments (the second component). The adjustments allow the LDC to correct for any over- or underrecovery in the previous quarter, by spreading those over- or underrecoveries over estimated sales in future quarters. The calculation of the adjustments is complex because several errors in estimation have to be compensated for:

- The error in the estimate of the gas price for the previous quarter;
- The presence of any refunds from the natural gas supplier of the LDC; and
- The errors in estimates of gas sales that may have caused earlier adjustments to over- or underrecover.

Over the long term, neither the LDC nor its customers bears a risk of over- or underpayment because the GCR mechanism assures that the LDC receives from the customer exactly what the LDC prudently paid for the natural gas, no more and no less. As noted earlier, LDCs file GCR rates quarterly. The Staff reviews the calculations for mathematical accuracy prior to the GCR rates going into effect. Periodically thereafter, either annually or biennially, the Commission conducts in-depth audits of each LDC that has a GCR mechanism to determine whether the GCR rates were accurately determined and properly applied to customer bills. Additionally, the Commission conducts in-depth audits of the management policies and operational procedures of each LDC to determine whether the company has used prudent and reasonable policies in purchasing gas to achieve an adequate and reliable supply of natural gas.

Because GCR rates are updated quarterly and apply prospectively, they lag market prices, such that, during periods of rising gas prices, the market prices paid by the LDCs may be higher than the GCR rates in effect. Because of the adjustments made to correct prior estimations, it is possible that GCR rates may increase (causing higher end-use customer bills) at a time when market prices are falling. While the GCR mechanism over the long-term provides a beneficial function of leveling gas charges on end-use customer bills, thereby allowing customers to better budget and plan for cost changes, it does not reflect rapid and unpredictable changes in wholesale natural gas costs.

That is what occurred during the fall of 2000 and the 2000-2001 heating season, when wholesale natural gas prices rose and continued to rise for a number of months. A number of LDCs in Ohio submitted their quarterly GCR filings under the normal schedule. However, during the period in which a particular GCR was in effect, several LDCs² experienced even higher costs in acquiring gas for their customers than they had estimated. They believed that to delay recovery of the dramatically higher wholesale commodity costs would only keep future GCR rates significantly higher, possibly even into the following summer months. As a result, they sought to adjust their existing GCR rates midcycle to capture, more readily, the rapid and unpredicted changes in their wholesale commodity costs. The Commission approved those midcycle requests. While this further explains why Ohio consumers experienced higher-than-normal, significant GCR rate increases during the past heating season, some companies that did not seek midcycle adjustments are experiencing large adjustments to their GCR rate at this time.

Ohio LDC customers felt the effect of the wholesale commodity costs from the summer and fall of 2000 through the GCR rates that followed. These customers also felt the effect of further increases to GCR rates during the 2000-2001 heating season because of the midcycle adjustments. However, those adjustments allowed the LDCs to better recover their wholesale commodity costs contemporaneously with the time they were incurred. This effort may also allow GCR rates to decrease more readily in the future and be more reflective of typical commodity charges, if wholesale commodity prices

² Those LDCs that sought midcycle GCR adjustments include: The Cincinnati Gas & Electric Company (CG&E), The East Ohio Gas Company d.b.a. Dominion East Ohio (Dominion), The Dayton Power and Light Company, Suburban Natural Gas Company, and Eastern Natural Gas Company.

decrease in the short-term and GCR adjustments do not negate wholesale commodity price decreases.

3. Effect of the Gas Price Increases on the Gas Cost Recovery Rates

The following table shows the recent EGC, adjustments, and GCR rates for three of the large LDCs in Ohio, namely CG&E, Columbia, and Dominion, in \$/Mcf:

Table 5: Recent Estimated Gas Costs, Adjustments, and Gas Cost Recovery Rates of LDCs with Gas Choice Programs, January 2000-March 2001

	<u>CG&E</u>			<u>Columbia</u>			<u>Dominion</u>		
	<u>EGC + ADJ = GCR</u>			<u>EGC + ADJ = GCR</u>			<u>EGC + ADJ = GCR</u>		
2000									
January	3.77	-.16	3.61	4.81	-	4.81	4.00	-.25	3.76
February	3.77	-.16	3.61	4.31	.30	4.61	4.00	-.25	3.76
March	3.56	-.15	3.41	4.31	.30	4.61	3.84	-.10	3.74
April	3.56	-.15	3.41	4.31	.30	4.61	3.84	-.10	3.74
May	3.56	-.15	3.41	4.71	.39	5.10	4.03	.15	4.18
June	4.62	-.43	4.20	4.71	.39	5.10	5.39	.15	5.53
July	4.62	-.43	4.20	4.71	.39	5.10	5.39	.15	5.53
August	4.62	-.43	4.20	6.32	-.06	6.26	5.75	.39	6.15
September	4.82	-.21	4.60	6.32	-.06	6.26	5.75	.39	6.15
October	4.82	-.21	4.60	6.32	-.06	6.26	5.75	.39	6.15
November	4.82	-.21	4.60	7.34	.04	7.38	6.80	.38	7.18
December	6.09	-.26	5.83	7.34	.04	7.38	6.80	.38	7.18
2001									
January	6.09	-.26	5.83	7.34	.04	7.38	6.80	.38	7.18
February	6.09	-.26	5.83	8.62	.03	8.65	8.13	.58	8.70
March	7.41	.31	7.72	8.62	.03	8.65	8.13	.58	8.70

(Errors of one cent are due to rounding)

4. The Competitive Suppliers' Rates

If the end-use customer is participating in one of Ohio's three natural gas choice programs by buying gas from a competitive supplier, the customer would pay, in addition to the LDC's base rate, the competitive supplier's commodity rate instead of the LDC's GCR rate. CG&E, Columbia, and Dominion currently offer gas choice programs in Ohio. Choice customers have saved millions of dollars since the first program began nearly four years ago. While the competitive suppliers' rates are often below the existing GCR rate of the LDC, it is not uncommon for competitive suppliers to offer a rate that is above the GCR rate. The competitive suppliers' proposed rates may change at any time. Many competitive suppliers charge a rate that is a percentage decrease off of the LDC's GCR rate. The Commission does not audit or regulate the competitive suppliers' rates. Competitive suppliers usually require an applicant to agree to be a customer of the supplier for a certain period of time. If the applicant obtains a fixed rate for the gas supply, then the customer's cost of gas should remain

constant over the term of the contract. If the applicant obtains a variable rate for the gas supply, the rate will rise or fall based upon the terms of the agreement.

5. Effect of the Gas Price Increases on Competitive Suppliers' Rates

The following table shows the average prices in \$/Mcf offered to customers by the competitive suppliers in the CG&E, Columbia, and Dominion gas choice programs:

Table 6: Recent Rates Charged by Some of the Competitive Suppliers, January 2000-March 2001

<u>Month</u>	<u>CG&E Program</u>	<u>Columbia Program</u>	<u>Dominion Program</u>
2000			
January	3.52	4.86	-
February	3.52	4.83	-
March	3.61	4.95	-
April	4.27	5.05	-
May	4.15	5.16	-
June	4.27	5.32	-
July	4.56	5.60	4.20
August	5.26	6.35	6.76
September	4.93	6.62	6.76
October	4.93	6.83	7.03
November	4.93	7.27	7.03
December	7.06	8.07	6.85
2001			
January	6.49	9.98	8.20
February	N/A	9.63	9.24
March	N/A	9.56	9.25

C. What was the Impact of the Gas Price Increases on Ohio's Natural Gas Choice Programs?

Many Ohio consumers do not purchase their natural gas from a LDC, but instead have selected competitive suppliers under three natural gas choice programs in Ohio. When a customer selects a competitive supplier to provide natural gas, the gas is still delivered to the customer by the LDC. Even with the high wholesale commodity prices this past winter, some customers with multi-year, fixed-rate competitive supplier contracts purchased gas at bargain rates compared to GCR customers or customers with variable rates. However, during this same time period, some consumers, for various reasons, lost the benefit of contracted lower cost gas.

The recent increase in gas prices presented challenges and opportunities for both customers and competitive suppliers participating, or considering participating, in Ohio's gas choice programs. It is difficult to overstate the effect that the wholesale gas prices have had on consumers. However, absent consumer research, it is equally difficult to measure the extent to which, and the exact reasons why, consumer behavior

may be affected. Nevertheless, this past winter's heating bills got the attention of the general public. The prices provided consumers with much more incentive to explore alternatives because people are looking for ways to save money on their utility bills. Media attention focusing on gas prices and the California electricity crisis also helped increase consumer awareness and interest in the choice programs. Moreover, increased awareness in the Dominion service territory can also be attributable to consumer education conducted by that LDC as part of the recent expansion of its choice program for all consumers in its service territory. As this program expanded in 2000, consumer awareness of this program increased to approximately 95 percent in December 2000.

With the increased awareness, consumer response not only increased, but was sharply negative about both price and competitive supplier activities during the past winter heating season, as evidenced by complaints to the Commission, the Ohio Consumers' Counsel, and LDC call centers. In January 2001, the Commission's call center was operating at a record level. The increase in gas-related calls over previous months was almost entirely attributable to questions and issues related to prices and concerns about competitive suppliers. A significant number of callers in January 2001 and prior months expressed concern about being returned to the LDCs' default GCR rates. The specific difficulties encountered by both consumers and competitive suppliers are summarized below.

1. Ability to Compare and Compete with the Gas Cost Recovery Rates

There are a number of factors affecting how consumers decide whether to take advantage of choice and which alternate natural gas supplier to choose. One of those factors is how that competitive supplier's offered price compares to the LDC's GCR. The fact that the GCR does not provide a timely comparison, as explained earlier in this report, is a first concern. While it is natural to compare a competitive supplier's rate with the GCR because the GCR is the cost of gas shown on the customer's bill, this type of comparison may lead consumers to make decisions that are actually not in their best interests. This is because the GCR can mislead the consumer into thinking he/she will be saving money when, in fact, he/she may not. For example, in a period of falling wholesale commodity prices: (1) the GCR will not respond to the fall as quickly as some competitive supplier rates due to the quarterly update process, and (2) the GCR may remain elevated as a result of adjustments for prior periods. As a result, the consumer may choose to switch to a competitive supplier when, over the course of a full year (or other contract period), he/she would, economically, be better off with the LDC. Similarly, in a period of rising prices: (1) the GCR will not respond to the rise as quickly as competitive supplier rates due to the quarterly update process and (2) the GCR may remain depressed as a result of adjustments for prior periods. As a result, the consumer may choose to stay with the LDC when, over the course of a full year (or other contract period), he/she would, economically, be better off switching to a competitive supplier.

To further illustrate this point, assume a consumer is considering options among three suppliers. The choices the consumer has are:

- Option A: A one-year, fixed-rate contract with a competitive supplier at five percent below the GCR.
- Option B: A one-year, fixed-rate contract with a competitive supplier at \$5.00/Mcf.
- Option C: Stay on the LDC's GCR rate, which is \$4.80/Mcf.

Based on this information, our hypothetical consumer would most likely choose the first contract, as it renders the lowest price of the three, based on the current GCR. Let us now assume that the GCR at the end of the quarter rises to \$5.60/Mcf:

- Option A is now \$5.32/Mcf (5.60 x 95 percent)
- Option B is still at \$5.00/Mcf
- Option C is now \$5.60/Mcf (the new GCR rate)

In this example, Option B would have been, in retrospect, a better choice for the consumer. A similar problem occurs when the prices are falling. Thus, as consumers faced questions of selecting a gas supplier in the fall and/or beginning of the 2000 winter season, when gas prices were increasing, comparisons and decisions were difficult to make.

In addition to the difficulty that rapidly changing prices pose for consumers trying to make intelligent choices in a competitive market, competitive suppliers under Ohio's choice programs also faced difficulties. The recent rapid price increases impacted the competitive suppliers' abilities to compete with the LDCs price wise. As discussed earlier, the GCR:

- Limits the LDC to quarterly changes;
- Shields both the LDC and the LDC consumer from some of the effects of price volatility; and
- Allows the LDC to defer costs for recovery in the future.

From a regulatory standpoint, this is all beneficial, as it mitigates the effect of price changes on GCR customer bills, allowing those customers to better budget and plan for cost changes, in addition to generally increasing consumer confidence. However, because it does mitigate the effect of rapid price changes, the GCR mechanism directly affects and may distort the decisions made by consumers and competitive suppliers in the natural gas market.

The prices offered by competitive suppliers are determined completely differently than GCR rates. The prices offered by competitive suppliers, therefore, do not necessarily mitigate price changes:

- The competitive supplier may change its offerings weekly or even daily;
- The supplier bears the risk of getting too little for the gas it is selling, but has the opportunity to make money; and

- The customer bears the risk of paying too much, but has the opportunity to save money.

In times of rising wholesale commodity prices, competitive suppliers are likely to struggle to remain competitive or exit the market because of the difficulty of competing with the slower rising GCR while still maintaining an adequate profit margin. Conversely, in times of falling prices, competitive suppliers should enter the market aggressively because the GCR will tend to drop slower than the actual cost of gas, leaving a greater opportunity for profit and growth of its customer body. The Staff has noticed from the 2000-2001 heating season that the number of consumers participating in the choice programs diminished as prices rose, and some customers were returned to LDC sources of supply as a result of competitive supplier actions. While the competitive suppliers struggled during this past heating season to obtain their own natural gas supplies at increasing acquisition costs, they also struggled to continue fulfilling then-existing contractual obligations, while also competing for additional customers.

Competitive suppliers had difficulty maintaining rate plan options (as represented by their inclusion in the Commission's Apples to Apples chart) throughout 2000. The number of options offered by competitive suppliers in the Columbia program decreased from 27 in January 2000 to 7 in January 2001. The Dominion gas choice program, which expanded to a company-wide program, grew from 3 options in July 2000 to 12 in October 2000, but fell back to 6 by the start of 2001. CG&E has the lowest GCR rate of the three companies offering gas choice programs. The number of options offered by competitive suppliers in the CG&E program alternated between 2 and 3 throughout 2000. A number of competitive suppliers also scaled back or froze efforts to acquire new customers during the 2000-2001 heating season. A couple of the competitive suppliers even released portions of their customer base.

Besides the number of rate plans offered, the variety of rate plan options offered by the remaining competitive suppliers decreased during the period of rapid wholesale commodity price increases. Consumers previously were offered either fixed-rate plans for the life of the contract or discounts off of the incumbent LDC's GCR rate. As the competitive suppliers faced increasing wholesale commodity costs to acquire their own gas supplies, those types of offers dwindled and variable rate offers remained or were introduced. By the very nature of a variable rate contract, consumers encountered more difficulties in evaluating their options going into the winter heating season. Moreover, consumers with variable rate contracts did not necessarily fair better. Some of the variable rates exceeded GCR rates.

Competitive suppliers' market positioning and response to market conditions determines in large measure the choices available to Ohio consumers. In Ohio, fewer competitive suppliers are active in the marketplace than prior to the rise in prices, thus limiting choice and further eroding confidence in the retail market. The foregoing illustrates that the rapid changes in wholesale gas prices greatly impacted consumers' abilities to compare and make wise decisions. The competitive suppliers likewise have struggled to acquire adequate gas supplies, while also honoring existing contracts and gaining new customers while offering few options.

2. Enrollment Issues

Most consumers wishing to enroll in gas choice programs have signed up without difficulty over the past several years, yet there have been some noted problems with the enrollment processes. These problems were magnified by the stresses of this past winter heating season.

Customer enrollment in the choice programs is a four-step process. In step one, the competitive supplier solicits the consumer through a variety of techniques. Competitive suppliers use direct mail, telemarketing, door-to-door sales, and the Internet to attract customers. In step two of the process, the competitive supplier obtains the customer's consent on an enrollment application and electronically forwards the information to the LDC for processing. In step three, the LDC electronically processes the application. As part of this effort, the LDC determines if the consumer is eligible for the choice program. The LDC notifies the competitive supplier when an applicant is rejected. Reasons for rejection may include, but are not limited to, bill arrearages or an incorrect account number, which make the consumer ineligible for the choice program until the reason for rejection is corrected. In the fourth step, the LDC sends a "welcome postcard" to the customer to confirm that the customer has switched suppliers.

The third step of the enrollment process varies among the three choice programs. CG&E accepts and processes competitive supplier enrollments on any day of the month. After receiving the competitive suppliers' requests, that LDC processes the account information within a two- to four-day period. Initial gas flow takes place following the customer's next meter read, within approximately 30 days. When compared to the Columbia and Dominion choice programs, choice customers in CG&E's territory will, on average, receive both initial gas flow from the competitive supplier and their initial bill with the competitive supplier rate in the shortest turnaround time, approximately one to two months after enrollment.

The Columbia and Dominion choice programs allow competitive suppliers less flexibility when enrolling consumers. Competitive suppliers are given a "cut-off" date each month by which they must submit consumer information in order for Columbia and Dominion to process the information for initial gas flow for the next month. On average, this approach causes a longer delay for the competitive supplier's initial gas flow date to the customer and may also cause a longer delay for the competitive supplier's rate to first appear on the customer's bill. The turnaround time under this enrollment process can be as long as four months after enrollment. Moreover, since none of the LDC billing systems has the capability to instantaneously change the source of a customer's commodity gas supply, the timing involved in this third step of the enrollment process also depends on each customer's billing cycle, which, in turn, is based upon the date the customer's meter is read.

The built-in time lag for effectuating enrollments can impact consumers' anticipated benefits when selecting a competitive supplier or converting to another competitive supplier or the LDC. The time lag can be more problematic or unacceptable to consumers during periods of volatile prices or high consumption periods, such as this past winter heating season. A delay in receiving a contract rate for

four months or even one month can negate a consumer's anticipated "benefit of the bargain". This was a particular concern to consumers this past heating season because some consumers were charged even higher rates than they had already experienced during the lag time. The consumer did not always anticipate the higher "interim" bills.

Some choice customers in the CG&E and Columbia programs were given the opportunity this past winter to terminate their contracts with their competitive supplier before the expiration of the contracts. Because of the enrollment period "cut-off" date in the Columbia program, a large number of customers attempted to timely cancel their competitive supplier contracts and revert to the LDC, but were unable to do so. As a consequence, a number of customers were forced to remain with the competitive supplier for the month of January 2001 and were charged a rate more than double that of the GCR. CG&E's enrollment system would not have resolved this situation completely, since enrollment is still based on the customer's meter read date, but, on average, the customer transfers would have taken place in a shorter time.

Some consumers experienced slow enrollment during this past winter when some competitive suppliers held enrollment applications beyond the cut-off date. This precluded the LDC from processing a timely switch. Some competitive suppliers negotiated customer contracts without defined start and end dates. This allowed suppliers to delay processing applications. Most customers were under the impression that the competitive suppliers would use their best efforts to process the customer's application during the next LDC enrollment window, but customers were unclear when their new contract rate would apply. Some customers' enrollments with competitive suppliers were delayed for more than three months because the competitive supplier held the enrollment application. In these situations, for example, residential consumers who enrolled in November 2000 were at a considerable disadvantage since they lost the benefit of the competitive supplier's rates for the winter heating season, which typically accounts for more than 50 percent of the residential consumers' yearly consumption. It is possible that the competitive suppliers were motivated to delay enrollment for some of their contracts because increased wholesale gas prices diminished profit margins.

None of the LDC tariffs under which the choice programs operate specifies a time limit for competitive suppliers to submit a new enrollment application to the LDC to be processed. The lack of such a requirement is a problem for the choice programs, competing suppliers, and consumers. This problem with the enrollment process was more acute this past winter because of the increases in gas prices, causing some customers to pay higher gas prices than they expected.

3. Competitive Supplier/Customer Contract Issues

Consumers encountered other problems with the choice programs that stemmed from the rapid increase in wholesale gas prices. Competitive suppliers breached contracts, failed to deliver gas to the LDC on behalf of customers, or failed to provide the promised savings. Some customers' accounts were sold. In two cases, the acquiring competitive suppliers tried to change the terms of the existing contracts with their new customers, even after making guarantees to the contrary. Some of these activities likely occurred because competitive suppliers were attempting to mitigate their rapidly increasing wholesale gas costs. A more in-depth summary of what transpired follows.

Over the last two years, twelve competitive suppliers were acquired by other competitive suppliers or their customer base was purchased. Most acquisitions were handled smoothly and customers were not adversely affected. However, supplier-to-supplier acquisitions did have some negative impact leading to customer frustrations, confusion, and disappointments, especially when customers were unable to remain with the competitive supplier they chose. In some instances, frustrations were compounded when various acquiring competitive suppliers attempted to alter the customer contracts and distributed multiple mailings with contradictory information to their customers. As an example, last summer after Keyspan sold its customer accounts to MX Energy, Keyspan sent its residential customers a letter stating that, although their contracts would be transferred to MX Energy in July 2000, the change would affect neither the price nor any of the terms and conditions of their contracts. The same day, Keyspan also sent a renewal letter to those of its customers whose contracts expired on July 31, 2000. The second letter informed them that their contracts would renew at five percent off the incumbent LDC's GCR rate, a significant increase over Keyspan's original rate. The customers who received both letters were especially confused. One letter told them that they were being transferred to MX Energy, but there would be no changes in the price or terms and conditions of their contracts; the other indicated that their existing contracts would be renewed, but there would be a rate increase. When the situation was brought to the attention of the companies, they worked with the affected customers to clarify the situation and help avoid a similar situation from occurring again in the future. Nevertheless, this is an example of actions taken by competitive suppliers to mitigate the wholesale price increases and the resulting effect upon customers.

Because the high wholesale, commodity gas prices made it difficult for competitive suppliers to make attractive offers to consumers (as explained earlier in this report), some competitive suppliers stopped enrolling new customers and others breached their contracts and exited the programs. High prices also made it difficult for competitive suppliers to be willing to honor low, fixed-rate contracts that were made when wholesale gas prices were low. In fact, the volatile marketplace produced a variety of code of conduct³ noncompliance issues, breaches, and defaults by competitive suppliers.

When some suppliers declared that they were no longer participating in the programs, their customers reverted back to the LDC and its GCR rate. By November 2000, Pooled Energy, Firestone, and D&L voluntarily exited the programs and prematurely terminated their customers' contracts, thus forcing their customers to either find another supplier or go back to the LDC's GCR rates. Table 7 shows the number of customers terminated by Firestone and D&L, as well as the estimated, additional costs their customers had to pay in November 2000. Complete information for Pooled Energy, which had 150 customers, was not available.

³ Each of the LDC's choice programs, as tariffed, includes code of conduct provisions. Those provisions provide some minimal behavior requirements to which the competitive suppliers must adhere in order to participate in the choice programs. The codes of conduct were designed to provide consumers with some protection against various unacceptable marketing and contracting practices.

Table 7: Competitive Suppliers Voluntarily Exiting the Choice Programs, November 2000

<u>Marketer</u>	<u>Approximate Number of Customers</u>	<u>Average Contract Price/Ccf</u>	<u>GCR Rate/Ccf</u>	<u>Estimated Additional Costs</u>
Firestone	400	\$.4974	\$.7351	\$7,971
D&L	8,000	\$.3983	\$.7351	\$225,213

A large number of customers were affected when their competitive supplier was terminated from a choice program. Energy Max, Summit Energy, Nicole, and The Energy Cooperative ended their participation in the choice programs by stopping delivery of gas to the LDCs, forcing the LDCs to terminate them from the program, as well as for other code of conduct, non-compliance issues. Terminating those competitive suppliers resulted in higher prices for customers. Table 8 shows the Staff's estimate of the total savings that the affected customers of three of the competitive suppliers lost by being charged the GCR rate, instead of their contract rate, during the first month after the competitive suppliers were terminated. Complete information for Nicole, which had 307 customers, was not available.

Table 8: Competitive Suppliers Terminated from the Choice Programs, September 2000-January 2001

<u>Marketer And Month Terminated</u>	<u>Approximate Number of Customers</u>	<u>Average Contract Price/Ccf</u>	<u>GCR Rate/Ccf</u>	<u>Estimated Additional Costs</u>
Energy Max (September 2000)	8,200	\$.3945	\$.6259	\$41,760
Summit Energy (December 2000)	3,500	\$.4780	\$.7351	\$135,334
The Energy Coop. (January 2001)	10,000	\$.3400	\$.7414	\$906,104

Some customers had the opportunity to enroll with another competitive supplier before they were returned to the GCR; however, not all customers had this opportunity. This difference is due to the different billing systems involved with the choice programs. Columbia uses a "bill-rendered" system, whereas CG&E and Dominion use a "service-rendered" system. In the bill-rendered system, customers will be charged a new price on the date the new price is made effective, namely, the date the supplier was terminated from the program. Bills distributed to the terminated competitive supplier's customers on the date following termination reflected the GCR rate because those affected customers automatically reverted back to the LDC. Conversely, under the service-rendered system, the new rate will apply only after the customer's next actual or estimated meter reading. When a competitive supplier was terminated from one of these programs with the "bills-rendered" billing system, the gas consumed between the time when the competitive supplier was terminated and the time when the customer's meter is read or usage is estimated was billed at the competitive supplier's rate.

Because of this time lag, these latter customers could switch to another competitive supplier before the next meter reading or estimate and, thus, would never be billed at the GCR rate. This has been termed a “seamless transfer” from one competitive supplier to another.

In another instance, Stand Energy guaranteed its customers savings over the Columbia GCR rate. However, in January 2001, Stand Energy charged its customers a rate more than twice the Columbia GCR rate. On average, residential customer whose one-year contracts expired in January 2001 with this particular supplier paid an estimated \$184 more than GCR customers paid over the same period. Customers whose contract expired in February 2001 paid an estimated \$267 more than the GCR customer paid over that same period.

Another example of a unilateral action occurred when The Energy Cooperative altered 18,000 customer contracts to eliminate a low, fixed rate and substitute a higher variable rate. The competitive supplier temporarily switched customers back to their original contract price after discussions with CG&E, the Staff, and the Ohio Consumers’ Counsel. Nevertheless, the competitive supplier was thereafter terminated from that program after failing to deliver gas to the LDC for its customers. From November 2000 through April 2001, these customers have collectively paid an estimated \$2.5 million more than what they would have paid if their original contract price had been honored.

These incidents illustrate that a number of competitive suppliers have engaged in improper market behavior, often in an attempt to mitigate the recent, rapid increase that they experienced in wholesale gas prices. Consumers are, to some extent, protected from abusive business practices through the code of conduct provisions contained within the LDC’s tariffs. However, customers who were impacted by some of the above-detailed competitive supplier misconduct have had little or no recourse within those tariffs because the tariffs do not provide, for instance, remedies to recoup money lost due to market abuses.

4. Complaint Handling

Certain unacceptable marketing practices, such as misleading or deceptive marketing practices, have continued to occur throughout the four-year history of the gas choice programs. As noted above, Stand Energy guaranteed its customers savings over the GCR, but its customers were charged over twice that of the GCR rate for January 2001. Stand Energy has only partially addressed this matter by crediting those customers who have contacted it, but has not credited the remaining customers who have yet to complain. The Staff does not believe that Stand Energy has appropriately responded to the situation or resolved the complaint.

In the last example from the above section, The Energy Cooperative’s unilateral alteration of 18,000 contract rates was only temporarily changed after discussions with the LDC, the Staff, and Ohio Consumer’s Counsel. The Staff also does not believe that that competitive supplier appropriately responded to the situation.

Misleading and deceptive practices have also occurred under outbound telemarketing. Outbound telemarketing was added as an enrollment method in the

choice programs over the past year. A significant advantage to the outbound telemarketing process is the ease of contacting a large consumer base in a short amount of time at relatively low cost to the competitive supplier. It also allows for joint marketing of both gas and electric choice to consumers. The advantage to consumers is the simplicity of enrolling over the phone rather than completing an enrollment form that must be delivered to the competitive supplier. However, there are disadvantages to telemarketing. Most disadvantages experienced thus far have been based on competitive suppliers' misleading and deceptive practices to enroll consumers. For example, the Commission has received complaints from consumers who state that the telemarketing agents presented themselves as representatives of the LDC. In other cases, the agent would not disclose the price or other terms of the customer contract. These types of complaints regarding the actions of competitive supplier agents must also be addressed and eliminated.

In another circumstance, similar inappropriate practices were experienced at one time with competitive supplier door-to-door marketing activities. However, in June 2000, the Commission acted to curb the inappropriate door-to-door practices. The Commission approved a set of guidelines governing door-to-door solicitations as part of all three LDCs' codes of conduct. Violation of these guidelines can result in suspension or termination of the supplier from the choice programs. Since these guidelines have been in place, the number of consumer complaints related to door-to-door activities has dropped considerably. This situation illustrates how a uniform set of guidelines for all three programs can address complaints in a fair and consistent manner.

D. Potential Remedies

Prior to 2000, natural gas prices had been relatively stable for a number of years. Most LDCs and competitive suppliers agree that relying on stable wholesale gas prices is a thing of the past. The price rise in natural gas in 2000 may have certain positive effects, including forcing consumers, LDCs, and competitive suppliers to face the realities of a competitive marketplace. However, the natural gas price rise also highlighted certain problems and created new problems that should be remedied.

1. Remedies for the Gas Price Increases

As natural gas prices have escalated of late, so too have the number of drilling rigs and production. A dramatic increase in drilling rigs and production should begin to have a positive supply impact going into the winter of 2001-2002. February 2001 data shows a North American rig count of 1,698, which is a 30 percent jump over February 2000 data. Assuming the production levels from these rigs are normal, consumers should benefit from the recent higher drill rig counts and production in the future. In fact, natural gas futures prices, as reflected in the New York Mercantile Exchange futures market, currently project natural gas prices that are significantly lower than prices this past winter. While the new production did not meet or exceed demand levels in time to eliminate the short-term pain of higher retail prices for natural gas during the 2000-2001 heating season, there is a possibility that the new production will increase supply sufficiently to affect prices. Thus, across the nation and in Ohio, the

natural gas industry's response to market dynamics may assist in remedying the price increases already experienced.

While natural gas spot prices and futures prices have trended significantly downward from last year's highs, the extent to which this trend continues remains to be seen. With today's tight natural gas supply and high oil prices, high oil prices will likely continue to sustain high natural gas prices at least in the near term. Additional gas-fired electric generation facilities are planned and under construction throughout the country, thereby influencing the upcoming summer demand for natural gas and the prices for refilling gas storage. While Ohio has yet to become a significant market for natural gas as a fuel source for generating electricity, a number of new generating facilities in Ohio have received regulatory approval in the past two years, all of which, if constructed, would use natural gas as a fuel source. Specifically, since the summer of 1998, the Ohio Power Siting Board has granted certificates for facilities capable of generating nearly 6,000 megawatts of electricity for consumption in the state. Therefore, that new, potentially significant demand source has not yet materialized in Ohio's data, but appears likely to develop in the near future. Other forces, such as weather, impact the supply and demand of natural gas in Ohio and can result in price increases. Consumer conservation efforts and budget payment plans can help to alleviate the impact of higher gas bills, but are unlikely to significantly impact or eliminate the root of the recent price increases – the imbalance between supply and demand.

2. Remedies for Ohio's Natural Gas Choice Programs

Many of the difficulties that consumers recently experienced in the Ohio choice programs are a result of "ripple effects" of a fairly small number of significant, identifiable issues, rather than a broad, systemic problem with the concept of natural gas choice. Thus, the future success of retail natural gas competition in Ohio will depend on resolving a small number of basic issues satisfactorily:

- Consumer understanding of natural gas choice programs and how to make an informed decision about an alternative supplier.
- Certainty and consumer confidence in the ability of competitive suppliers to be able to do business reliably, and in the existence of some oversight.
- Consistency in the availability of natural gas choice and in the requirements for participation.

Competitive suppliers have the opportunity to capitalize on the new level of consumer awareness and interest resulting from high utility bills so as to increase the level of consumer participation in the choice programs. In order to take advantage of increased consumer awareness and interest resulting from higher gas bills, competitive suppliers must overcome negative attitudes and perceptions that have developed in response to higher bills and fewer choices. Even so, it cannot be denied that customers who have chosen alternative suppliers have accepted a degree of price risk based on their preferences and, thus, consumers can be willing to accept certain risks.

Equally important to information for consumers is credibility, which underlies consumer confidence. Recent competitive suppliers' marketing practices, failures to supply gas, and failures to honor fixed-price contracts have engendered skepticism. Competitive suppliers' advertising and promotional mix may, in the future, need to emphasize staying power, stability, and the ability to meet contractual commitments. Of course, in order to succeed, competitive suppliers need to live up to such promises.

Opportunities for improving and remedying the problems that developed during the recent past also exist on both the demand and supply sides of the business. On the demand side, consumers have an interest in lowering their high gas bills and, therefore, consumer interest in alternatives exists. The challenge for competitive suppliers is how to capitalize on this interest. On the supply side, there appears to be opportunity for competitive suppliers to offer attractive prices, especially compared to the LDCs' gas commodity rates of this past winter. Gas futures prices show some moderation, affording the opportunity for competitive suppliers to acquire more affordable gas supplies and achieve reasonable margins, while also offering favorable, predictable rates. Consumers may be less willing to assume risks associated with variable price contracts. Pricing strategies such as "percent off the GCR" may also be more difficult to implement at \$8.00 GCRs than at lower price levels. However, it is likely to be more difficult for competitive suppliers to maintain the prior percent saving levels to customers when the absolute value of that savings level doubles, particularly given the size and diversity of a GCR portfolio of gas contracts and the experience of LDCs.

It also appears that the new market dynamic may call for better competitive supplier positioning in terms of occupying a market niche that is responsive to one or two consumer perspectives. For example, the general competitive supplier marketing strategy seems to have largely been to achieve "per Mcf savings" relative to the GCR.⁴ Since consumers have experienced the effects of price volatility, there may be a subset of them that, on the one hand, desire absolute price certainty rather than some uncertain level of savings. On the other hand, consumers may be looking for price stability within a reasonable range and may be willing to lock into longer term price commitments that are favorable compared with LDC rates.

Additionally, the introduction of Electric Choice on January 1, 2001, offers the prospect for more entrants into the Ohio gas retail market. New entrants will likely include entities that intend to market both gas and electricity. Early indications on the electric side indicate that new market entrants may include well capitalized, sophisticated companies that are familiar with risk management and back-office operations.

The price rise served as a wake-up call for more aggressive risk management by competitive suppliers. The higher commodity prices themselves raised the bar to market entry and made it more difficult to sustain an active market presence. The suspension of offers by competitive suppliers who had been active prior to the recent price rise alone indicates that these risks may not have been adequately hedged, given

⁴ As explained earlier in this report, the more appropriate comparison is between competitive supplier rates and the EGC.

the market conditions that developed. Market discipline will require competitive suppliers to have financial staying power and successfully manage both price and volume risks. Additional risk management will cost money, which will be passed on to customers.

Back-office operations offer the final key to success for the competitive suppliers to serve customers and their accounts. This includes customer account tracking, complaint resolution, and billing. Some competitive supplier failures may have been attributable, at least in part, to not knowing which customers had paid and which customers were in arrears. When such basic problems exist, it is difficult to maximize the value of accounts receivable, maintain cash flow, and manage credit risk. It is for these reasons that competitive suppliers must also focus upon effective and efficient back-office operations.

The price rise also served as a wake-up call for more aggressive risk management by the LDCs because supplier credit risk is a major factor. LDCs are reviewing their credit requirements, which were set during choice program startup periods at levels that would encourage, or at least enable, vigorous market entry. For the LDCs, the time of rising prices caused credit risk to be even more of a concern. Any nonperformance by competitive suppliers carried a heavy burden for the LDC because of the increased price of gas supplies it needed to meet the returned customers' needs. Also, there is increased likelihood of default of smaller competitive suppliers whose own risk is increased. In order to protect their exposure as providers of last resort, LDCs will likely be more cautious about the financial protection they require. In addition to LDCs' concerns about risk management, the Staff has learned that some wellhead suppliers also have already instituted more stringent credit requirements, including prepay requirements for higher risk competitive suppliers.

The Staff recommends that the LDCs begin the use of risk management tools (e.g., hedging) to try to bring greater certainty to the cost of gas to be included in the GCR. The Commission should permit implementation of such programs to gain experience and to document the processes that are used and the results. The Staff also recommends that any risk management tools that are used should be included as part of the cost of gas so that all the transaction costs and all the results receive the same consideration for recovery. The review of risk management programs should receive individualized consideration for each LDC, to recognize the philosophies, tools, and operating differences between the LDCs. The prudence of such programs should be based on the circumstances and information available at the time that such decisions were made.

Additionally, the trend to consolidate competitive suppliers has already started and is likely to continue. Several smaller players have either been absorbed by larger concerns or their customer base has been purchased. This trend is likely to be offset by new market entry by entities seeking to serve both electric and gas to consumers. This trend may assist the ailing competitive suppliers.

As noted earlier, the primary enforcement tools available for dealing with competitive suppliers that have violated LDC tariffs and codes of conduct are the extreme penalties of termination or suspension from the gas choice program. These

tools do have adverse consequences. First, when a competitive supplier is terminated, customers no longer are charged their contracted rate. Second, competitive suppliers complain that the LDC's unilateral right to either suspend or terminate them from the choice programs leaves them with few due process rights. Finally, where the LDC has an affiliate in the competitive market, the LDC may be open to charges of anti-competitive behavior. The results of such actions provide consumers with limited protection against market abuses, offer few remedies within the program, and lack the appearance of objective due process. Further, the LDCs' unilateral right to suspend or terminate a competitive supplier for violating code of conduct provisions does not provide the customers or the competitive supplier with any immediate recourse.

While this report was being developed, the General Assembly passed and the Governor signed a new law that should also remedy some of the enforcement problems that have been most recently experienced with the choice participants. When effective, Amended Substitute House Bill 9 expressly grants (in Section 4929.24, Revised Code) the Commission the authority (upon complaint of any person or upon its own initiative) to consider complaints against competitive suppliers and to specifically determine whether the competitive suppliers have violated or failed to comply with certain newly enacted statutory provisions.⁵ Additionally, the Commission is required by Section 4929.22, Revised Code, to adopt minimum service standards applicable to competitive suppliers (and any governmental entity acting as an aggregator for the provision of competitive retail natural gas service). Such minimum standards shall include consumer protections relating to:

- (1) Disclosure of adequate, accurate, and understandable pricing and terms and conditions of service in contracts;
- (2) Terms for qualifying for, switching, or discontinuing competitive supplier (or aggregator) service;
- (3) Minimum customer bill contents;
- (4) Requirements for disconnection or termination of competitive service;
- (5) Minimum service quality, safety, and reliability; and
- (6) Disclosure of customer information.

Finally, in Section 4929.24(B), Revised Code, the Commission is expressly granted authority to order the rescission of a contract between a competitive gas supplier and one or more of its customers, to order a competitive gas supplier to provide restitution to one or more of its customers, and to order a competitive gas supplier to pay a forfeiture.

The Staff believes that these statutory authorizations and directives will allow the Commission to put into place a number of legal requirements that will help eliminate the reoccurrence of many of the marketing improprieties that occurred during the past heating season. They should help deter the competitive suppliers from altering contract

⁵ Nothing in this statement should be construed to indicate any change in the Staff's position regarding the Commission's jurisdiction to address any of the complaints against competitive suppliers that have been or will be filed with the Commission. The Staff maintains its position that the Commission has authority to address the many complaints, as expressed in its January 23, 2001 brief filed in *Ohio Consumers' Counsel v. Energy Max of N. E. Ohio, Inc. et al.*, Case No. 00-2074-GA-CSS.

terms without customer consent, for example. In these rules, the Commission may also address a time limit for competitive suppliers to submit new enrollment applications to the LDC, the lack of which has been a problem for some consumers. We would be remiss to suggest that these new requirements will eliminate all improper competitive activities, but we do believe the new requirements will reduce them dramatically. Furthermore, the new law will provide consumers, LDCs, or other competitive suppliers with immediate recourse opportunities through an independent, third party (the Commission). The Staff looks forward to working to develop appropriate Commission rules that meet the requirements of Amended Substitute House Bill 9 and help eliminate many of the problems encountered in the choice programs during the recent, rapid increase in wholesale natural gas prices.

Finally, the new law also adds a new dynamic to Ohio's competitive natural gas market. Aggregation of consumers by governmental entities is expressly permitted to occur. Since similar aggregation efforts have taken place in the electric industry, the knowledge and experience gained by governmental entities from electric choice may assist in "jump starting" governmental aggregation in natural gas competitive market.



Conclusion

The recent increase in natural gas wholesale and retail prices has resulted from market forces that have disrupted the flow of energy nationwide. The price increase has caused confusion and difficulties for suppliers and consumers in Ohio and assuredly elsewhere. Market forces are already at work to respond to the imbalance. The natural gas industry is responding to the supply imbalance by deploying more drilling rigs and increasing production. However, bringing supply and demand into balance is not an easy task. The Ohio LDCs and competitive suppliers are and should assess the events of the last several months to avoid similar reoccurrences, particularly in times of extreme weather. Consumers are becoming more sensitive and knowledgeable about utility issues and the opportunities to mitigate price increases. The Staff recommends that the LDCs begin the use of risk management tools (e.g., hedging) to try to bring greater certainty to the cost of gas to be included in the GCR. The Commission should permit implementation of such programs to allow the LDCs to gain experience. The Staff also recommends that any risk management tools that are used should be included as part of the cost of gas so that all the transaction costs and all the results receive the same consideration for recovery.

The Staff has taken and will continue to take actions to ensure that the price increase recently experienced can be less devastating. The Commission itself will evaluate whether the price increase contained on LDC bills is the result of prudently incurred wholesale commodity costs (as part of the GCR audit process) and whether the various difficulties that choice customers experienced can be avoided (as part of the creation of new administrative rules required by recent legislation). There may possibly be other formal and informal investigations initiated as needed. Additionally, the Commission is active in providing information to the public so that it can have the necessary information needed to make wise utility-related decisions.

Finally, we note that attached as an appendix to this report is a listing of helpful and informative publications and Internet links. These additional sources of information may prove enlightening to those seeking additional information on the subject.



Appendix

Further Reading for Natural Gas Market Information

Statement of Mark J. Mazur, Acting Administrator, Energy Information Administration, Department of Energy, Before the Committee on Energy and Natural Resources of the United States Senate, December 12, 2000.

Fact Sheet: High Monthly Natural Gas Bills and Their Economic Impact. Glenn R. Schleede of Energy Market & Policy Analysis, Inc., February 5, 2001.

Residential Natural Gas Prices: What Consumers Should Know. National Energy Information Center, January 2001.

Residential Natural Gas Prices: What Consumers Should Know. Public Utilities Commission of Ohio.

The Other Energy Crisis. Cambridge Energy Research Associates, January 18, 2001.

ICF Consulting's Natural Gas Market Outlook Links High Natural Gas Prices to Higher Crude Oil Prices, July 6, 2000.

Continental Response Will Address Natural Gas Price Shock. Cambridge Energy Research Associates, September 20, 2000.

Record Cold Winter Played Major Role in Higher Natural Gas Bills. Peggy Laramie and Daphne Magnunson, American Gas Association, January 9, 2001.

New Report Says Natural-Gas Prices Could Drop By Summer. Will McNamara, Director Electric Industry Analysis, Sciencetech, February 6, 2001.

Natural Gas Prices for March Fall 21% Nationwide as Decline goes into Second Month, According to Platts. Businesswire, March 5, 2001.

Columbia (of PA) Customers See Price Decrease. Increases in Natural Gas Supply Prompted the Decrease Request. York Daily Record, March 13, 2001.

Internet Links for Further Reading

<http://www.aga.org>

<http://www.simmonsco-intl.com>

<http://www.eia.doe.gov>

<http://www.businesswire.com>

<http://www.bakerhughes.com>

<http://www.consultrci.com>



The Public Utilities Commission of Ohio
Bob Taft, Governor

Alan R Schriber, Chairman

Ronda Hartman Fregus, Commissioner
Judy A. Jones, Commissioner
Donald L. Mason, Esq., Commissioner
Clarence D. Rogers, Jr., Commissioner

Internet Address
www.puc.state.oh.us

The Public Utilities Commission of Ohio is an
Equal Opportunity employer and Service Provider