Ontario Energy Board

FILE No. EB-2008-0219

EXHIBIT No. HD3.1

DATE May 14, 2009

08/99

COMMENTS TO THE PENNSYLVANIA PUBLIC UTILITY COMMISSION

Docket No. I-00040103

Investigation into Competition in the Natural Gas Supply Market

Comments of Direct Energy Services, LLC

I. INTRODUCTION

Direct Energy Services, LLC ("Direct Energy") files these comments in response to the Commission's Order of May 28, 2004, initiating an investigation to determine the level of effective competition in the retail natural gas industry in Pennsylvania and requesting comments on means for encouraging increased competition.[1]

Direct Energy is submitting comments in this proceeding because the outcome will significantly impact its ability to compete effectively for residential and small commercial natural gas customers in Pennsylvania. Direct Energy, through itself and its affiliates, supplies gas to millions of retail customers in the United States and Canada, offering retail customers fixed-price and price protection programs to mitigate customer concerns about constantly fluctuating energy rates. We serve about 30,000 residential and small commercial natural gas customers in Western Pennsylvania. Direct Energy is a subsidiary of Centrica, a retail energy service provider in the United Kingdom with over $21 billion in market capitalization which serves over 20 million natural gas and electric service households.

Direct Energy's Interest In The Proceeding

Direct Energy believes that markets are superior to regulation to determine the price of energy products that consumers purchase, and that market based solutions are the best and most effective and efficient means by which to meet consumer needs.

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1 Direct Energy is an indirect wholly owned subsidiary of Centrica plc and an affiliate of Energy America LLC. Energy America LLC is a licensed natural gas supplier authorized to supply retail customers in Pennsylvania. Direct Energy serves its existing Pennsylvania customers through its affiliate Energy America.

Direct Energy has achieved notable success in several markets in the U.S. and Canada in which it either serves as the default or "price to beat" service provider or has acquired customers in the competitive market. In serving *electric* customers in the U.S., Direct Energy provides an "all in" service including billing and customer care service, and acts as the single point of contact for electric service (acting as agent for the customer to acquire and pay for the EDC's distribution service). In serving *natural gas* customers, Direct Energy typically provides supply and maintains a customer call center, but the incumbent utilities bill the customers on behalf of Direct Energy.

To be able to provide greater choice to consumers the Commission must establish a competitive retail natural gas market in which rates for default service reflect market forces as much as possible, where the default service provider is responsible for all of the risks of providing that service and, therefore, is responsible for its success or failure in the marketplace, and where the rules do not favor the default service provider over alternative suppliers or permit the incumbent utility to gain a competitive advantage over alternative suppliers through creative affiliate relationships. Direct Energy's position on these issues is informed by its affiliate's experiences in the United Kingdom where competitive electric and gas markets have resulted in switching by almost ½ of all customers, and customers have experienced substantial savings. Competitive markets can and do work.

II. COMMENTS ON THE QUESTIONS CONTAINED IN THE COMMISSION'S ORDER

1. *Assessment of the level of competition in Pennsylvania's natural gas supply service market.*

Pennsylvania's gas market has been open since 1999, with statistics on the market dating from late 2001 available from the Office of the Consumer Advocate. These statistics show that the percent of residential customers obtaining supply from licensed suppliers has been steadily decreasing.

Percent of Residential Customers Served by Alternative Suppliers

	10/01/01	1/01/02	7/01/02	7/01/03	7/01/04
Columbia Gas	31.9	31.4	31.2	24.4	21.8
Dominion Peoples	35.4	35.1	32.9	28.6	26.3
Equitable Gas	11.4	10.3	10.2	8.9	8.3
State	12.6	12.3	12.0	9.9	7.3

http://www.oca.state.pa.us/cinfo/gstat.htm

In a healthy and competitive market, the percent of customers participating will grow over time. These statistics show that the level of competition in the Pennsylvania market is low and has been decreasing.

2. *Effect of the price of natural gas on competition.*

The price of natural gas offered by alternative suppliers is reflective of prevailing market conditions, the length of the term of the contract offering and the suppliers' internal costs. Currently suppliers compete against offerings by other suppliers and the incumbent utilities' Supplier of Last Resort ("SOLR") gas commodity rate (GCR) offering. As long as a utility remains in the merchant function, its GCR is viewed as the price to beat by consumers and other industry stakeholders. That this is the case is clearly set out in the Residential Natural Gas Shopping Guide by the Pennsylvania Office of Consumer Advocate. According to this booklet, any savings a consumer can achieve are simply described as "the GCR less the supplier price":

Price to Compare		$ 4.00/Mcf
New Supplier Price	-	3.00/Mcf
Savings		$ 1.00/Mcf
Savings		$ 1.00/Mcf
Monthly Use	X	10 Mcf
Savings per Month		$10.00

www.oca.state.pa.us/gascomp/gasguuide.pdf

This is not an accurate representation because the GCR is portrayed as being directly comparable to alternative suppliers' offerings, but it is not because it's subject to adjustment up to 4 times a year. Also, offerings by suppliers are not limited to one-year fixed price contracts, making a GCR comparison even less accurate. In other markets Direct Energy and its affiliates have offered multi-year fixed price products, multi-year declining price products, and monthly variable price products. Having to compete against a GCR which is understood by consumers to be a fixed price offering but which does not accurately reflect current market prices or all costs of providing the service not only limits the number of suppliers that will enter a market (thereby limiting consumers choices), it also reduces alternative suppliers' ability to make unique and original offerings to consumers, further limiting the options available to consumers. Consumers that understand natural gas pricing can make informed comparisons and decisions. Outreach, information and education efforts by utilities and government should provide accurate information that will assist consumers to make informed decisions based on accurate information.

In markets where the utility continues to provide gas supply, the main competition to offerings by suppliers is the utility's GCR. If the GCR is set to properly reflect prevailing market prices and all of the utility's costs associated with providing gas to customers, suppliers can effectively compete against the GCR.

Similar to Direct Energy's presentation at the Commission's electric POLR Roundtable in the Spring of 2004, natural gas SOLR GCR service must be priced "at market" and fully reflect all costs associated with providing this service, including:

- All gas procurement expenses
- All customer migration expenses
- All administrative costs
- All operational costs
- All customer care costs, including bad debt and customer care

In order for the GCR to properly reflect market prices it should be set at prevailing market prices, adjusted regularly and not be subject to true-ups or retroactive adjustments. Ideally the GCR should be adjusted monthly, with the price established and publicly available one month prior to being in place. As long as the utility continues to offer a GCR product which does not reflect prevailing market prices and all costs associated with providing that product, alternative suppliers are competing against an artificially low price and a competitive market will not develop.

3. Effect of customer information/service on competition.

While customer service by alternative suppliers is an important aspect of their business and a potential area of differentiation among alternative suppliers, customer service by the incumbent utility should not impact a consumer's decision on whether or not to purchase supply from an alternative supplier. All consumers should be assured of the same level of service by the incumbent distribution utility no matter what company they purchase their natural gas from.

The ability of alternative suppliers to access customer information is important for suppliers to be able to provide gas supply and other services to that consumer in the most effective manner. Once a consumer has made the decision to move to an alternative supplier, all information processed by the incumbent utility that is relevant to the customer's gas supply and consumption (including historical usage) should be available to the alternative supplier without cost.

4. *Effect of supplier financial security requirements on competition.*

Financial security requirements are an expected cost of doing business and any security requirements placed on alternative suppliers by incumbent utilities should properly reflect the economic risk that the incumbent utility incurs due to the alternative supplier operating in its territory. The methods of meeting security requirements should be flexible enough to allow alternative suppliers to choose the most appropriate method for meeting the requirements. Therefore, a supplier with a high credit rating from one or more credit rating agencies should be able to use this credit rating to substantially reduce or eliminate the amount of any monies or securities it must post as a security requirement. Additionally, alternative suppliers should be able to use a parental guarantee for the amount of the security required when the alternative supplier's corporate parent has a high credit rating. While financial security requirements should protect the incumbent utility against risk, there needs to be flexibility in how alternative suppliers can meet these requirements. Security requirements should not be used as a means to effectively stop new entrants from entering a market.

5. *Effect of natural gas distribution company penalties and other costs on competition.*

Competitive markets are more likely to succeed in an environment where there is open access to information required by all market participants, be they suppliers examining whether to launch new offerings or consumers examining various supplier offerings before deciding which supplier to purchase their gas from. The PUC should establish that alternative suppliers have the right to access utility information the suppliers see as being necessary or useful to allow them to serve consumers effectively in Pennsylvania. As the Pennsylvania market continues to evolve and mature, the information required by suppliers may change. Therefore, ensuring that alternative suppliers will have access to the information they see as necessary or useful is an important component of facilitating the development of competition in the market.

There are a number of utility practices and requirements that add directly or indirectly to the cost of providing natural gas supply to Pennsylvania consumers, or do not allow alternative suppliers access to all of the information they require to operate efficiently, such as the following.

- Billing fees. The fees charged by incumbent utilities to provide billing services for alternative suppliers should be reflective of the cost of providing this service to the suppliers.
- Customer moves. Currently, PUC regulations do not allow contracts to move with customers, even if they move within their current utility's service territory. Customers that have chosen to enroll with alternative suppliers

should be able to continue to receive their gas supply under the terms they have enrolled for. Customer supply contracts with alternative suppliers should be able to move with the customers if they move within their current utility's service territory.

- Delivery of natural gas to the utility. Columbia Gas of Pennsylvania ("CPA") requires alternative suppliers active in its service territory to deliver flat amounts of gas throughout the year, rather than delivering gas to match their customer's demand. While this simplifies the process for alternative suppliers, it causes uniformity in how suppliers supply natural gas instead of allowing each alternative supplier to meet their customers' demand in the manner they see as being the most efficient and economical. Requiring the utilities to have suppliers' deliveries match their customers' demand should reduce the administrative and operational workload placed on the incumbent utilities, thereby reducing the utility's costs, while also giving suppliers the ability to purchase supply to satisfy their customers' demand in the most economically efficient manner they can.
- Local production. Alternative suppliers should be able to purchase natural gas from producers located behind the city gate. Currently, alternative suppliers with customers in CPA's service territory cannot purchase natural gas from local producers, thereby reducing the range of supply options available to these suppliers. This also unnecessarily deprives customers and CPA of the many benefits of local gas production, such as potentially lower commodity

cost, higher BTU content, and lower GCR (through avoidance of interstate supply and its associated costs).

- Penalties. CPA currently charges alternative suppliers a penalty of $75/mmbtu for non-delivery, which is not reflective of either actual costs or market costs. While it is reasonable that incumbent utilities should not lose money when suppliers fail to deliver, alternative suppliers should not be subject to charges greater than the costs the utility incurs or the market costs resulting from non-delivery. Any penalties which utilities charge to alternative suppliers should be the lower of the utility's costs or market-based rates (for instance, Gas Daily index in the case of non-delivery). In the electric market, the model is basically to charge suppliers the market-based rate for mismatches, and the same should be true for the natural gas market.
- Receivables. When they provide consolidated billing, incumbent utilities should be required to purchase receivables from alternative suppliers at no discount. In most jurisdictions, the receivables discounts charged by the incumbent utility to alternative suppliers are between 0% and 1%. If the receivables fee charged by a utility is set above 0%, it should be uniform for all alternative suppliers and the GCR price should reflect the same charge as a cost component.
- Reconciliations with marketers. If utilities continue to require flat delivery from suppliers, they should be required to provide reconciliations based on an historical published index, with the cost of gas weighted by volumetric imbalance. If alternative suppliers' deliveries match their load, the utilities

should be required to perform monthly reconciliations with suppliers. Having alternative suppliers move to daily deliveries matching demand would enable the utilities and alternative suppliers to reconcile volumes on a monthly basis, which would provide greater transparency on price, reduce alternative suppliers' costs and increase the efficiency of the market. Providing alternative suppliers with timely information on their deliveries and the demand of their customers will enable them to better understand the market and ensure that they are delivering gas in the most efficient manner they can to satisfy their customers' demand.

- Customer renewals. Alternative suppliers should be allowed to renew customers in a cost-effective manner which allows flexibility in setting the price, terms and conditions of the renewal offer. Being able to inform their consumers of renewal prices and changes to the terms and conditions of the contract for the renewal period as closely as possible to the renewal date, while ensuring that the customers are given adequate notice of the new terms and conditions, allows alternative suppliers the flexibility to provide their customers with the most attractive renewal offer they can. To ensure that customers are provided with adequate notice of the expiration of their current contracts and the renewal terms being offered, alternative suppliers should be permitted to send renewal information, including the new price and any changes to the terms and conditions, to customers one time no more than 90 days and no less than 30 days in advance of the expiration dates of customer contracts.

- Uniform rules: Where possible, the rules, fees and information-sharing requirements between utilities and alternative suppliers should be uniform across Pennsylvania. Uniform rules will allow alternative suppliers to understand the requirements of providing service in any utility service territory in Pennsylvania, thereby reducing costs and barriers to entry. Without uniform rules, alternative suppliers face additional costs in meeting the unique requirements of each service territory they enter.
- Utility disclosure of information to suppliers: Alternative suppliers require clear and open access to the incumbent utilities' transport costs, updated information on storage, and information on the utilities' daily injections and withdrawals to ensure they are being properly allocated access and costs associated with their products. By having access to this information, alternative suppliers can better understand their customers' needs and control their costs, thereby enhancing the competitiveness of the Pennsylvania natural gas market.

6. Discuss any avenues, including legislative, for encouraging increased competition in Pennsylvania.

Competition is the law of the land in Pennsylvania. The Commission recently demonstrated its support for competitive markets in its decision on Duquesne Light Company's electric POLR III Plan. To encourage increased gas competition in Pennsylvania, the decisions and actions by the Commission must similarly state and reinforce the legislative policy that competition is the right tool to deliver the best service to natural gas consumers.

As discussed earlier, as long as the incumbent utility continues to offer GCR service, alternative suppliers are competing primarily against the utility, against the utility's GCR offering, and against Pennsylvania consumers' perception that the GCR is a fixed price offering. Having a GCR service offered by the incumbent utility presents the most significant barrier to establishing a competitive market for natural gas in Pennsylvania because it reduces the ability of marketers to effectively compete, educate and offer different products to consumers. GCR service can be priced artificially low by a number of different methods, including: not reflecting prevailing market prices, being subject to potential true-ups at a later date, and not including all costs properly associated with providing this service. Additionally, having the incumbent utility's GCR service portrayed by either government agencies or the utility as the price consumers should compare to alternative suppliers' offerings does a disservice to consumers and the competitive market because it does not promote or help educate consumers on unique or new offerings from alternative suppliers.

To promote effective competition and as authorized by Section 2207 of the Gas Competition Act, the Commission should approve alternative suppliers to provide SOLR service to Pennsylvania consumers that have not chosen to receive their gas supply from alternative suppliers. The Commission should also consider a retail auction to determine who will act as the SOLR in each utility's service territory, with the Commission defining pre-conditions for potential bidders to properly safeguard Pennsylvania consumers. By having a retail auction for this service, the Commission, alternative suppliers and potential new entrants can be assured that all of the costs of providing this service will be properly reflected in the SOLR price, thereby creating a more competitive market for all Pennsylvania consumers.

III. CONCLUDING REMARKS

Pennsylvania has experienced large amounts of customer switching since the gas and electric markets were originally opened to competition. The initial rate of customer switching that has occurred in Pennsylvania shows that marketers will enter and compete for customers when they see that they can effectively compete and that consumers will respond to marketer offerings and to price signals. By moving the Pennsylvania natural gas market to a more competitive state, consumers will benefit from the choices that will be provided by alternative suppliers.

The Commission can also show its commitment to the development of a competitive natural gas market by establishing a set of objective criteria which, when met, will deem the Pennsylvania gas market fully competitive. After these criteria have been met, the SOLR should be free to establish the price it charges for gas supply without constraint from the Commission.

Respectfully submitted,

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Date: August 27, 2004