A COMPARATIVE OVERVIEW OF THE UNBUNDLING OF GAS DISTRIBUTION SERVICES IN NORTH AMERICA — LESSONS FOR NOVA SCOTIA AND NEW BRUNSWICK

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After a brief introduction to the policy and historical background of the regulation of gas distribution services, the authors review the main issues surrounding the unbundling of such services by examining numerous models from Canada and the United States. Particular consideration is given to the effect of unbundling on the small commercial and residential customer. The article concludes with a discussion of unbundling in greenfield jurisdictions and cites recent developments in Nova Scotia and New Brunswick to illustrate legislative response to some of the specific issues raised.

Après avoir présenté brièvement la politique et l'historique de la réglementation des services de distribution du gaz, les auteurs abordent les principales questions que soulève le dégroupement de tels services en examinant de nombreux modèles au Canada et aux États-Unis. Ils accordent une attention particulière à l'incidence de cette pratique sur les petits clients commerciaux ou les particuliers. En conclusion, ils parlent du dégroupement dans des régions entièrement nouvelles et font état de l'actualité en Nouvelle-Écosse et au Nouveau-Brunswick pour illustrer les mesures législatives prises en réponse à divers problèmes.

TABLE OF CONTENTS

I. INTRODUCTION AND BACKGROUND

A. INTRODUCTION

In the mid-1980s, the primary focus of energy policy discussions turned from the issue of security of supply, which had dominated since the early 1970s, to an emphasis

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on competition in energy markets. This change in focus was generally attributable to the deregulation philosophy of the Reagan administration and, more particularly, to the easing of supply shortages in energy markets in the mid-1980s with concomitant price declines, the unforeseen stagnation of energy consumption growth in many industrialized countries, and over-capacity problems. While competition is common among energy sources such as oil and coal, the constraints of "network-bound energy systems" such as electric and gas supply systems had until relatively recently impeded any real competition.[1]

Over the past several years, almost every local distribution company ("LDC") in North America has established unbundled transportation rates enabling industrial and large commercial customers to purchase their gas supplies on the competitive market. This innovation has resulted in significant savings for those customers. With that success, the focus of unbundling has turned to small commercial and residential customers. However, it is not certain if unbundling will benefit small customers. Critics question whether residential customers, or their agents, will be able to procure supplies and upstream pipeline capacity at lower costs than an LDC. They suggest that transaction costs for these low-load, high-reliability customers may significantly impair the chance of savings being realized.[2]

In this article, the authors have canvassed the key issues related to the unbundling of gas distribution services in North America. While many of the issues apply regardless of the customer, due to the current focus of unbundling efforts and the questions about the likelihood of their success at the small-customer level, the issues are presented predominantly as they affect residential customers. Specific developments in natural gas unbundling throughout Canada and the United States are addressed to give colour and depth to the key issues; however, the authors do not claim to have completed an exhaustive review of the myriad of approaches and developments in all jurisdictions. This article concludes with an overview of the gas distribution regimes soon to be implemented in Nova Scotia and New Brunswick to determine what lessons have been learned in these greenfield jurisdictions from the unbundling experiences throughout North America.

B. RATIONALE FOR THE REGULATION OF GAS DISTRIBUTION SERVICES

In North America, competition in the economy is relied upon to promote the public interest — to ensure that the right goods and services are produced at the right price. However, for every rule there is an exception. It has long been recognized that competition is not fully effective in certain industries, and that government regulation must be relied upon as a substitute to promote the public interest. These industries

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1 G. Kühne & W. Fox, Jr., "Competition in Network-Bound Energy Systems" in *Energy Law '90: Changing Energy Markets — the Legal Consequences* (Newcastle, UK: Athenaeum Press, 1990) 223 at 224-25. This article discusses gas and electric deregulation developments in Europe and provides an interesting comparison with North American jurisdictions.

2 K.W. Costello & J.R. Lemon, "Unbundling of Small-Customer Gas Services: New Challenges for State Public Utility Commissions" (1997) 18 Energy L.J. 137 at 137.

include those "which supply, directly or indirectly, continuous or repeated services through more or less permanent physical connections between the plant of the supplier and the premises of the consumer, and ... the public transportation agencies."[3] This diverse group of businesses has been the subject of detailed regulatory oversight and are known in common parlance as "public utilities." Public utilities are sometimes referred to as "natural monopolies"; essentially, they are businesses that operate most efficiently as monopolies. There is a high degree of public interest associated with the services offered by public utilities and, accordingly, regulation is used to serve ends other than those which the simulation of the results of competition would theoretically produce, including regional development, social welfare, and national defence.[4]

An LDC, an enterprise which distributes natural gas to end users, is generally considered to be a public utility under Bonbright's definition by virtue of its being a "public transportation agency." While LDCs have traditionally carried out gas supply functions, it is the distribution function which is vital to the public interest. Thus, even though an entire LDC's operations may have been subject to regulation, the LDC's recognized status as a public utility is generally predicated upon the distribution component of its services alone.[5]

C. A BRIEF HISTORY OF THE DEREGULATION OF THE NATURAL GAS INDUSTRY

In both Canada and the United States, federally regulated pipelines were traditionally required to purchase the gas they transported at regulated prices. LDCs (subject to provincial or state regulation, respectively) in turn purchased gas for their end-users from the pipelines. Thus, both pipelines and LDCs provided bundled service to their customers. Unbundling at the federal level was the genesis for unbundling at the provincial or state level.

Unbundling at the federal level began in Canada in 1985 with a series of intergovernmental accords, including the "Western Accord on Energy Pricing and Taxation" dated 28 March 1985 and the "Agreement on Natural Gas Markets and Prices" dated 31 October 1985 (known as the "Halloween Agreement"). Among other things, these agreements allowed LDCs to reduce their wellhead contract volumes and allowed customers to purchase gas directly at the wellhead.

Likewise in the United States, the *Natural Gas Policy Act*[6] had been passed in 1978, ensuring a gradual deregulation of gas wellhead prices. As a result, customers began to try to deal directly with gas producers, bypassing the transporters, who were still holding long-term contracts with the producers at prices well above the free market price. Nevertheless, those customers continued to need the pipelines to transport their

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3 J.C. Bonbright, A.L. Danielson & D.R. Kamerschen, *Principles of Public Utility Rates*, 2d ed. (Arlington, Va.: Public Utilities Reports, Inc., 1988) at 11.

4 C.F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice* (Arlington, Va.: Public Utilities Reports, Inc., 1988) at 3-4.

5 *Supra* note 3 at 12.

6 15 U.S.C. § 3301-3432 (1982).

gas. The structure in place was no longer appropriate. To get out of this deadlock, the Federal Energy Regulatory Commission ("FERC") issued a series of orders (*Order 380*,[7] *Order 436*,[8] Order 500,[9] and *Order 636*[10]) by 1985 that urged (or effectively forced) gas pipeline companies to shed their gas supply function in favour of the role of contract carrier, requiring them to transport gas owned by others. Free trade between customers and producers was facilitated through open access to pipelines (under *Order 436*), while the pipelines' contractual crisis was solved through unbundling of pipeline services (through *Order 636*) along with negotiated settlements between the pipeline companies and the producers over a period of years. This restructuring was accompanied by the entry of marketing companies and the opening of a variety of market centres supported physically by the rapid development of "hubs," pipeline pooling points with flexible storage facilities, exchange locations, and additional services. The natural gas restructuring process was made possible by a convergence of interests of the various players, along with the potentially very competitive original structure of the industry (a lot of producers, a lot of consumers, a lot of parallel pipelines) and the existence of a very dense pipeline network and numerous storage facilities which backed up the physical exchanges on the market.

II. UNBUNDLING OF GAS DISTRIBUTION SERVICES

Bundling of goods or services is a well known marketing strategy.[11] Bundling arises for three main reasons: (1) economies of scope (the cost savings realizable when one firm produces and sells different services together without duplication of effort); (2) technological interdependency (the bundled service has a greater value than the sum of its parts due to the close interaction of those services and a desire for seamless integration); and (3) demand interdependency ("you can't have one without the other"; the bundled service includes components that must be used together in order to have any value, *e.g.* a carpet cleaner and cleaning fluid).

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7 *Order No. 380, Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bills Provisions*, 49 Fed. Reg. 22,778 (1984) [hereinafter *Order 380*].

8 *Order No. 436, Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, FERC Stats. & Regs. Preambles 30,665 (1985), vacated and remanded, *Associated Gas Distributors* v. *FERC*, 824 F.2d 981 (D.C. Cir. 1987), cert. denied, 485 U.S. 1006 (1988), readopted on an interim basis, *Order No. 500*, FERC Stats. & Regs. Preambles 30,761 (1987), remanded, *American Gas Assoc.* v. *FERC*, 888 F.2d 136 (D.C. Cir. 1989), readopted, *Order No. 500-H*, FERC Stats. & Regs. Preambles 30,867 (1989), rehearing granted in part and denied in part, *Order No. 500-I*, FERC Stats. & Regs. Preambles 30,880 (1990), aff'd in part and remanded in part, *American Gas Assoc.* v. *FERC*, 912 F.2d 1496 (D.C. Cir. 1990), cert. denied, 111 S. Ct. 957 (1991) [hereinafter *Order 436*].

9 *Order No. 500*, (1988) 89 P.U.R (4th) 312 (F.E.R.C.) [hereinafter *Order 500*].

10 *Order No. 636, Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Wellhead Decontrol*, F.E.R.C. Stats. & Regs. Preambles 30,939 (1992), order on reh'g, *Order No. 636-A*, F.E.R.C. Stats. & Regs. Preambles 30,950 (1992), order on rehearing, *Order No. 636-B*, 61 F.E.R.C. 61,272 (1992), aff'd in part and remanded in part, *United Distribution Co.* v. *F.E.R.C.*, 88 F.3d 1105 (D.C. Cir. 1996) (F.E.R.C.) [hereinafter *Order 636*].

11 *Supra* note 2 at 141-43.

The specific services making up the bundled LDC services include retail distribution, arranging pipeline transportation, arranging storage, gas procurement, balancing services, investment in financial instruments for hedging programs, load forecasting and nominations, peaking services, back-up services and interruption insurance, accounting and billing, and maintenance contracts.[12] It is not the intention of regulators to unbundle every one of these services from the others, although there is likely some variation among the jurisdictions as to which services will be unbundled. Unbundling has an optimal limit, both in terms of the degree of separation of services and of the scope of customers who may benefit from it. With respect to the degree of separation, the risk is that economies of scope may be eliminated beyond what is necessary.[13]

There are certain inherent problems with bundled services, particularly in a public utility setting. Solving these problems is one goal of the unbundling movement. On the other hand, there are certain qualities of unbundled services that are desirable in and of themselves, apart from solving the problems of bundled services.

A. RATIONALE FOR UNBUNDLING

It has been said that the bundling of gas distribution services has imposed a cost on consumers and society in general. Meanwhile, for reasons of self-interest, LDCs have been quite content to offer only bundled services.[14]

1. PRICE DISCRIMINATION AND SELF-DEALING

Bundling may allow the seller to be paid more for the goods or services offered than it would have been paid under unbundled or uniform monopoly pricing.[15] Thus, bundling can be a tool of price discrimination.

> Discrimination occurs when a monopolist in effect conditions the purchase of its regulated service on the purchase of its unregulated product, creating a "bundle". This allows the firm to charge a supra-competitive price for the bundle that includes both the regulated service and the unregulated product. Supra-competitive prices will persist if competitors, who would offer natural gas at competitive prices, cannot gain access to the regulated monopolist's transmission services on terms similar to those the monopolist enjoys. As a result, the regulated firm may earn supra-competitive profits on the sale of the bundle of services, and the benefits of competition in natural gas sales are reduced or lost.[16]

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12 *Energy Report (Electricity and Gas)* (1 October 1996) (submitted to the Regulatory Flexibility Committee of the Indiana General Assembly) c. VIII, online: Indiana Utility Regulatory Commission <http://www.ai.org/iurc/report/regflex/gas/m-8.htm> (date accessed: 27 April 1999).

13 *Supra* note 2 at 145-46.

14 *Ibid.* at 141.

15 *Ibid.* at 143.

16 J.A. Eaton, "The Dance of Regulation and Competition: Regulation and Deregulation of the Natural Gas Industry in the United States" in *Proceeding of OECD/World Bank Conference on Competition and Regulation in Network Infrastructure Industries* (Paris: OECD, 1995) 119 at 120, online: OECD <http://www.oecd.org/daf/clp/bdpt103.htm> (date accessed: 27 April 1999).

In the gas distribution business, if regulatory oversight of bundled pricing was perfect, an LDC would not be able to charge more for its total service offering than the costs of the individual components of that service plus a reasonable return. However, there exists an imbalance in access to information, and the regulator will not always be able to ascertain the true costs of individual components; this is particularly so where those components are sourced in non-arm's-length transactions with LDC affiliates (this can be classified as a separate problem called "self-dealing," the practice of paying one's unregulated affiliate supra-competitive prices for inputs which artificially increases the rate base or revenue requirement in the regulated market).[17]

There are three possible approaches to dealing with regulatory evasion through price discrimination and self-dealing. The first is strict regulation of the price of the bundled service. This approach theoretically would preserve the operating efficiencies resulting from economies of scope but would limit the possible efficiencies that could be gained by allowing one or more of the services included in the bundle to be provided in a competitive market. Experience has shown that strict regulation is inferior to competition in meeting public interest goals.

> In the gas industry one can observe that only where there has been confidence that competition would meet the social and political goals of the government that competition has been allowed to play its fullest and best role. Concurrently it can be said that it was not economic theory but the practical failure of over-inclusive regulation to meet these goals, coupled with the success of the market in meeting them, that led to significant deregulation of the industry.[18]

The second option for dealing with price discrimination and self-dealing is the forced divestiture of the competitive product as provided under anti-trust and competition laws. This option has an impact that is the reverse of the previous one; it would encourage competitive pricing for the non-monopoly portion of the services but may sacrifice economies of scope that arise from vertical integration.

The third option is to unbundle the services, that is to force the regulated firm to "purchase" regulated services from itself on terms and conditions comparable to those available to competitors. Like the second option, economies of scope may be sacrificed in achieving competitive gains. The difference between the second and third options is that the second option relies purely on anti-trust and competition oversight, whereas the third option requires a combination of anti-trust and competition oversight and utilities regulation.[19]

2. CROSS-SUBSIDIZATION

> Cross-subsidization entails shifting costs associated with unregulated activities into the regulated rate base. Such strategies would allow a gas pipeline with monopoly power effectively to raise its

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[17] *Supra* note 2 at 143.

[18] *Supra* note 16 at 120-21.

[19] *Ibid.* at 120. See Part II.C.9 below for a brief discussion of the interface between utilities regulation, and competition and anti-trust regulation in an unbundled environment.

transmission rates above the actual costs of transmission, thereby raising the costs to other non-affiliated producers. The pipeline continues to incur only its actual costs.[20]

In addition to the shifting of costs between services, cross-subsidization may also occur as a shifting of costs among customer classes, thereby having residential bundled-service customers, for example, absorb some of the costs attributable to industrial unbundled-service customers so that an LDC may improve its competitive position in the industrial market.

3. OTHER ISSUES

The scope of regulatory oversight is reduced in an unbundled environment, and so regulatory costs are decreased accordingly.[21] In addition, removing the supply function from regulatory oversight and placing it in the hands of end users and unregulated marketers will increase the use of financial hedging tools to manage supply costs since most LDCs are limited by regulators in the extent to which they can make use of these tools.[22]

Unbundling provides customers with more choice, if nothing else, and will almost always benefit them for that reason alone. Moreover, the choices are given to the customer to make; the market performs better when purchasing decisions are made on the basis of the customer's needs and wants.[23]

Finally, it can be stated that, based upon economic theory and the experience of other industries, service unbundling at all levels appears to be a prerequisite for a fully competitive natural gas industry.[24]

B. THE STATUS OF UNBUNDLING IN NORTH AMERICA

1. CANADA

Canada is recognized as having considerable experience with retail natural gas competition and is often cited as an example for jurisdictions in the United States.[25] In particular, Ontario may be the jurisdiction which has come the furthest in North America in developing a workable, competitive residential market for natural gas.[26] It certainly has one of the longest histories with unbundling; the Ontario Energy Board first allowed direct gas purchases by customers in 1987.[27] By 1998, non-LDC gas suppliers were serving 40 percent of the residential market in Ontario. In addition, 90

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20 *Ibid.* at 120-21.

21 *Supra* note 2 at 147.

22 *Ibid.*

23 *Ibid.* at 144.

24 *Ibid.*

25 *Supra* note 12.

26 W. Harvie, "Brave New World: Natural Gas Retailing Accelerates As A Curtain Raiser On Competitive Utility "Convergence" In Ontario" (1998) 49 Oilweek 37.

27 *Supra* note 2 at 138, 140.

percent of commercial and industrial end-users in the province were also being served by those suppliers.[28] As of 6 May 1999, nineteen companies were licensed as gas marketers under the mandatory licensing scheme (which came into force on 1 March 1999) of the *Energy Competition Act*.[29]

Despite Ontario's leading role, Manitoba was actually the first province to implement rules permitting residential customers the opportunity to purchase gas from suppliers other than their LDCs. To varying degrees, the other gas-consuming provinces (*i.e.*, all but the four Atlantic provinces), have followed suit.

Residential customer participation in the provinces has steadily increased, ranging from 10 percent to 35 percent just four years ago, even though the number of alternative gas suppliers has declined over time as competition has weeded out the unsuccessful entrants. The provinces that showed the greatest decreases in price were those in which the provincial regulatory commissions were more aggressive in requiring unbundling of services.[30]

Initially, customers in the provinces enjoyed significant savings, since the spot price of gas at the wellhead (at which non-LDC suppliers were purchasing) was considerably less than the LDCs' weighted average cost of gas ("WACOG"), which was dominated by long-term gas supply contracts featuring inflexible pricing.[31] However, when the spot wellhead price of gas exceeded many LDCs' WACOG in 1993, the economics of the new retail gas business were no longer conducive to profit-making and a few of the non-LDC gas suppliers withdrew from service with the result that customers were shifted back to their LDCs.

The ease with which non-LDC gas suppliers were able to enter and leave the retail gas market prompted the Ontario Energy Board to conduct hearings and prompted the Direct Purchase Industry Committee, the Ontario retail gas industry organizing body, to prepare a code of ethics for non-LDC suppliers even though only 2 percent of customers were taking service from alternative suppliers at that time.[32] Since that time, Ontario has moved forward relatively rapidly with the establishment of affiliate codes of conduct for LDCs,[33] a report from the Ontario Energy Board proposing unbundling

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28 *Supra* note 26 at 37.

29 S.O. 1998, c. 15. The purpose of the Act is primarily to deal with a restructured electricity industry, but it also has implications for the natural gas industry, including greater regulatory consistency between gas and electricity, greater flexibility in establishing rates, licensing of marketers, and a rule-making authority. See also Bennett, *infra* note 64 and F. Laughren, "Balancing Public Policy, Regulation and Competition" (Address to the Ontario Natural Gas Association, 17 September 1998), online: Ontario Energy Board <http://www.oeb.gov.on.ca:80/speeches/ogma.htm> (date accessed: 20 May 1999).

30 *Supra* note 25.

31 *Supra* note 2 at 140.

32 *Supra* note 25. The code of ethics specified, among other things, the minimum notice period required before a customer could switch suppliers, the minimum duration that a customer must stay with a supplier, ethical standards for marketing personnel, and standardized disclosure statements.

33 *Re the Ontario Energy Board Act, R.S.O. 1990, c. O.13, sections 19 and 30* (15 May 1997), E.B.R.O. 492-03, E.B.R.O. 493-03, E.B.R.O. 494-04 (O.E.B.).

of LDC supply and distribution functions,[34] the establishment of a Natural Gas Market Design Task Force (the "Task Force") with full representation of interests to map out the unbundling process,[35] the enactment of deregulation-friendly legislation,[36] and the promulgation of a marketer code of conduct for dealing with customers.[37]

In British Columbia, the approach was to establish tight regulatory rules for non-LDC gas suppliers. Those suppliers were required to take pipeline capacity from the LDCs, to mitigate any stranded costs experienced by the LDCs, and to enter into long-term gas supply contracts. Initially, the British Columbia Utilities Commission approved unbundled access for only the largest industrial customers that were "knowledgeable." However, by 1992, the program was expanded to include commercial and residential customers, and the requirement for long-term contracts was eliminated.

Nova Scotia and New Brunswick have never had full-scale gas distribution services. With the production of natural gas from Sable Island expected to commence in November 1999, these two provinces have enacted gas distribution legislation and, as of this writing in May 1999, are both in the process of selecting gas distribution franchise-holders. How these provinces have applied the lessons learned in other jurisdictions is one focus of this article.[38]

2. UNITED STATES

Next to Ontario, California has had the longest running experience with retail unbundling. California was a leader in the United States in providing unbundled services to small commercial and residential customers.[39] Until fairly recently, California was the only state that had developed a meaningful track record of unbundling behind the city gate.

California began its Core Aggregation Transportation ("CAT") program in February 1991. The CAT program permitted core customers, primarily residential and small commercial customers together with a few industrial customers, to aggregate their loads so that they would be attractive to different gas suppliers. At first, "core customer" was defined as any customer that did not have any alternative fuel options. The CAT program was limited to participation by 10 percent of the total LDC volume and ten alternative suppliers. Customers participating in the CAT program could purchase all

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34 Ontario Energy Board, *Advisory Report to the Minister of Energy, Science and Technology on Legislative Change Requirements for Natural Gas Deregulation* (16 December 1997), online: Ontario Energy Board <http://www.oeb.gov.on.ca:80/decision.htm> (dated accessed: 20 May 1999) [hereinafter *Unbundling Report*].

35 Natural Gas Market Design Task Force, *Report to the Ontario Energy Board* (4 February 1999), online: Ontario Energy Board <http://www.oeb.gov.on.ca:80/decision.htm> (date accessed: 20 May 1999).

36 See *supra* note 29.

37 Ontario Energy Board, *Code of Conduct for Gas Marketers* (2 March 1999), online: Ontario Energy Board <http://www.oeb.gov.on.ca:80/legislation.htm> (date accessed: 20 May 1999) [hereinafter *Marketer Code*].

38 See the discussion at Part III.C below.

39 *Supra* note 2 at 138.

or part of their requirements from an alternative supplier, and the incumbent LDC would be responsible for providing remaining supplies. The alternative suppliers were required to purchase proportional pipeline and storage facilities from the LDCs. This had the benefit for the LDCs of limiting their stranded costs; however, it also reduced the economic benefits that could be realized by the alternative suppliers.[40] The CAT program was modified and expanded significantly in July 1995 when the California Public Utility Commission decided to reduce the recovery of stranded costs and to permit alternative suppliers to construct their own supply portfolio.

It has been said that the primary benefit of the CAT program may have been the stimulus it provided to the incumbent LDCs to increase their operational efficiencies and to provide customer awareness that unbundling and competition was a benefit to customers.[41] In spite of the successes in California, the state legislature, bowing to pressure from LDCs and LDC unions, passed two bills in August 1998 prohibiting the California Public Utility Commission from ordering any further restructuring of the natural gas industry.[42]

Beyond California, various states have taken to implementing "pilot programs" as an experiment to test residential service unbundling. Pilot programs are generally limited in scope (by gas volume, number of customers, duration, geographic area, *etc.*) and are approved by regulatory authorities. Several LDCs began such pilot programs for small commercial and residential customers in the fall of 1996.[43] One of these was the "GasAdvantage" pilot program proposed by Wisconsin Gas Company and authorized for an initial year by the Wisconsin Public Service Commission. GasAdvantage offered a group of residential and commercial customers in West Bend, Indiana, representing a total peak-day volume of up to 10,100 decatherms, the opportunity to procure their gas from alternative suppliers. The program involved mandatory upstream capacity assignment to gas suppliers and restricted residential customers from withdrawing from the program before the end of the winter heating season. The program attracted 818 residential customers and 650 commercial customers

40 The suppliers felt that they could purchase a more efficient portfolio of transportation and storage services if freed of the requirement that they purchase them from the incumbent LDC. In fact, the California Public Utility Commission has estimated that small customers were paying 70 percent more than large non-core customers for interstate pipeline capacity due to their inability to take advantage of competitive opportunities in the interstate transportation markets. As it happened, beginning in 1998, customers and marketers were given the opportunity to purchase interstate pipeline capacity on the competitive market. See *ibid.* at 139.

41 *Supra* note 25.

42 S.B. 1602, *An act to add Chapter 2.2 (commencing with Section 328) to Part 1 of Division 1 of the Public Utilities Code, relating to the Public Utilities Commission, and declaring the urgency thereof, to take effect immediately*, 1997-1998 Sess., California (chaptered 25 August 1998); S.B. 1757, *An act to add Section 341.5 to, and to add Chapter 2.2 (commencing with Section 328) to Part 1 of Division 1 of, the Public Utilities Code, relating to public utilities, and declaring the urgency thereof, to take effect immediately*, 1997-1998 Sess., California (enrolled 31 August 1998). See also "State Developments Special Report: Unbundling Of Natural Gas Services Unfolds Slowly In States As Marketers Question Profitability Of Pilots And Residential Markets" *Foster Natural Gas Report* (1 October 1998) 14, online: NEXIS (Energy, CURNWS).

43 The states which approved pilot programs for 1996 include California, Illinois, Iowa, Maryland, Massachusetts, Ohio, Pennsylvania, and Wisconsin.

that year and was approved for a second year, during which it had the participation of more than 1,400 residential customers and almost 700 commercial customers. GasAdvantage was approved for a third year, currently ongoing, with a 12 percent increase in the peak volume cap on participation.[44]

Like California, many of the states that have experienced rapid progress have seen their unbundling efforts stall, and some have even gone on to suffer a severe backlash. For example, by early 1998, the Kentucky Public Service Commission had established guidelines for affiliate transactions, including accounting and reporting obligations. After that, it began looking at tightening its control by establishing a formal code of conduct and rules.[45] However, as of March 1999, Kentucky has decided to put a hold on unbundling.[46] Massachusetts, one of the first states to implement a pilot program, initiated a collaborative process among marketers of natural gas and services, customer groups, government agencies, the regulator, and LDCs in July 1997, not unlike the Ontario Task Force, to develop a common set of principles for the restructuring of gas distribution services. The group issued two reports by March 1998. After that, the process broke down and the Massachusetts Department of Telecommunications and Energy was forced to delay competition until the spring of this year, citing continuing disagreements among participants in the process.[47]

Happily, there is still progress being made. The Georgia Public Service Commission issued a notice on 27 April 1999 requiring all customers to chose one of the nineteen registered gas marketers within 100 days, failing which one would be chosen for each of them (on an equal and random basis).[48] Georgia's statewide natural gas services program is expected to be a model to be watched by other state lawmakers.[49] Early this year, New Jersey mandated supplier choice for all customers by 31 December 1999.[50] As a next step, the board ordered LDCs to file unbundled rate schedules by 30 April 1999.[51] The Commonwealth of Virginia has passed a law requiring LDCs to file retail customer choice plans including an implementation plan for all customer classes starting 1 July 2000, open access tariffs, provisions for the recovery of non-

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44 "Retail Customer-choice Programs Move Forward In Several States" *Inside F.E.R.C.'s Gas Market Report* (26 June 1998) 10, online: NEXIS (Energy, CURNWS). See also *supra* note 25.

45 "Kentucky PSC Launches Examination Of Stringent Rules For Affiliates" *Gas Utility Report* (30 January 1998) 6, online: NEXIS (Energy, CURNWS). See also *Foster Natural Gas Report*, *supra* note 42.

46 "States Are Proper Arena For Crafting Customer-choice Programs, FERC Told" *Gas Utility Report* (12 March 1999) 7, online: NEXIS (Energy, CURNWS).

47 *Foster Natural Gas Report*, *supra* note 42.

48 The notice was given pursuant to *Re Rules Concerning Random Customer Assignment Under the Georgia Natural Gas Competition and Deregulation Act* (30 December 1997), 8053-U (Ga. P.S.C.).

49 *Foster Natural Gas Report*, *supra* note 42.

50 *Electric Discount and Energy Competition Act*, Pub. L. No. 1999, c. 23.

51 *Re the rate unbundling filings by gas public utilities pursuant to section 10, subsection A, of the Electric Discount and Energy Competition Act of 1999* (17 March, 1999), GX99030121 (N.J. B.P.U.).

discriminatory stranded costs, provisions for capacity release, and affiliate rules.[52] Ohio is enjoying a lively residential and commercial choice program with some thirty alternative gas suppliers vying for the 1.3 million eligible customers under Columbia Gas of Ohio Inc.'s program.[53]

Other unbundling initiatives are moving ahead at various paces in various places.[54] A recent government study[55] examined unbundling efforts across the United States as of 31 July 1998 by surveying LDCs and interviewing representatives of state utilities commissions, LDCs, and suppliers to determine the effect of customer choice initiatives on small-volume customers. The study found that forty-three LDCs in sixteen states had implemented customer choice programs for either residential or small commercial customers or both. A further eleven states were either considering, or were about to commence, such programs. The *GAO Study* estimated that 553,000 residential users, or 4 percent of the eligible customers, had elected to participate in a customer choice program. Among the thirty-four LDCs with residential customer choice programs, the individual participation rates, which averaged out to 4 percent, actually varied between zero and more than 50 percent. Notably, of the twelve LDCs in California and New York, the two states where the eligible customer base is largest, eleven had participation rates of less than one percent.

Notwithstanding the current low participation rates, according to the American Gas Association,[56] 18.3 million, or 33 percent, of the 54 million residential gas users in the United States will have the opportunity to obtain their gas from a non-LDC supplier if all proposed programs are implemented. That number goes up to 70 percent when one includes commercial, industrial, and co-generation gas users.

The current low levels of participation in residential customer choice programs have prompted many of the top energy marketing companies in the United States to wait before entering the residential gas market because the required investment is not yet likely to be rewarded. While recognizing the potential for profit in this sector in the future, these companies prefer to stay with wholesale markets where profitability has been proven. Their concerns with the residential market centre around the cost of gaining a customer as weighed against annual return realizable from that customer. These numbers have been quoted at $200 and $25 per year respectively, representing a 12.5 percent return on investment. Another concern is the fact that customers have

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52 *An act to amend and reenact § 59.1-199 of the Code of Virginia and to amend the Code of Virginia by adding a section numbered 56-235.8, relating to gas utilities; retail supply choice; consumer protection*, c. 494 (1999).

53 *Foster Natural Gas Report*, *supra* note 42.

54 *Supra* note 25.

55 General Accounting Office, *Energy Deregulation: Status of Natural Gas Customer Choice Programs* (December 1998) [hereinafter *GAO Study*]. See also "GAO takes hard look at choice programs" *Gas Daily* (23 December 1998) and C. LeGates, "Federal Report Analyzes Natural Gas Customer Choice Programs," online: NEXIS (Energy, CURNWS), (24 December 1998), online: Energy <http://www.energy.com/news/cover/cv122498.asp> (date accessed: 19 May 1999).

56 American Gas Association, *Customer Choice: Growth in Natural Gas Volumes* (Baltimore, MD: AGA Distribution Centre, 29 May 1998).

been slow to switch from their LDC suppliers. Enron Corporation ("Enron") may offer a particularly telling example. It has been an active participant in the retail gas sector, spending hundreds of millions of dollars on advertising targeting new customers in advance of full-scale deregulation.[57] At the same time, Enron has been active in petitioning state legislators and regulators to introduce gas supply competition at the residential level.[58] But in spite of its bullish role in advancing deregulation, recent reports indicate that Enron has decided to step back from the residential market and, like the other large marketers, focus on industrial and commercial customers.[59] Enron apparently does not believe that current retail markets offer opportunities that are attractive enough to warrant the associated expense and risk.

C. KEY ISSUES IN UNBUNDLING

1. THE UNBUNDLING PROCESS

The way in which the transition to full competition (*i.e.*, exit of LDCs from the merchant function) will come about is as much an issue as the unbundling itself.[60] Unbundling may occur through legislation or order or through regulatory rate-making.[61] Currently in the United States, eight states have issued legislation or comprehensive commission orders requiring LDCs to initiate rate changes resulting in choice for their customers,[62] and thirty others have either introduced limited open access programs or are considering unbundling proposals.[63] On the rate-making side, as of August 1998, ninety-seven LDCs in the United States had approved firm small industrial transport rates, seventy-five had transportation options for commercial

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57 "Appeal of Residential Market Uneven As Suppliers Seek New Opportunities" *Gas Utility Report* (27 February 1998) 9, online: NEXIS (Energy, CURNWS).

58 See *e.g. Inside F.E.R.C.'s Gas Market Report*, *supra* note 44.

59 *Foster Natural Gas Report, supra* note 42. Columbia Energy Group now appears to be the foremost agitator for residential customer access, particularly in the mid-Atlantic states.

60 The assumption is that full competition is the goal of unbundling. However, another point of view is that it is preferable instead to allow bundled and unbundled services to co-exist, at least during the transition period, since requiring an LDC to unbundle all of its services could be harmful to customers, particularly small customers whose transaction costs may be higher per unit for services consumed. See *supra* note 2 at 145.

61 There is a question as to whether regulatory bodies have the authority to make the necessary rulings to restructure the gas industry. See *e.g. infra* note 64. The Ontario Energy Board, for example, was of the opinion that the then-existing *Ontario Energy Board Act*, R.S.O. 1990, c. O.13., was "ill-suited" to the new unbundled environment, saying that it needed the authority to redefine monopoly services, refrain from regulation where appropriate, enforce codes of conduct, and protect consumers: *Unbundling Report*, *supra* note 34. See also "Ontario Energy Board Proposes Separate Natural Gas Supply And Distribution Functions And New Legislation, Paving Way To More Fully Deregulated Market For Natural Gas" *Foster Natural Gas Report* (22 January 1998), 21, online: NEXIS (Energy, CURNWS). The Ontario Legislature responded, enacting the *Ontario Energy Board Act, 1998* as a schedule to the *Energy Competition Act*, *supra* note 29. Many regulatory bodies have not concerned themselves with this issue and have used their rate-making authority to orchestrate the unbundling of distribution services.

62 Arizona, California, Georgia, Montana, Nevada, New York, Ohio, and Oklahoma. See online: Enron <http://www.ces.enron.com/choices> (date accessed: 30 April 1999).

63 The states with no competitive access or reform activity are Alabama, Alaska, Arkansas, Hawaii, Idaho, Mississippi, North Dakota, Oregon, South Dakota, Tennessee, Texas, and Utah. See *ibid.*

customers, and forty-four had the same for residential customers (either through pilot programs or standard rate options).[64]

Different parties have diverging views on the speed with which the transition to a fully unbundled market should occur. LDCs in Oklahoma are in favour of slowing the unbundling process and have succeeded in forcing the Oklahoma Corporation Commission to delay the start of retail competition in the state from 1 October 1999 to 1 June 2001.[65] Meanwhile, in Arizona, gas marketers have taken steps to speed up the process of opening up the gas industry to competition,[66] only to have competition postponed while LDCs battle over their right to recover stranded costs.[67] All parties have a role to play to ensure the unbundling process occurs quickly or even at all: regulators must be aggressive in monitoring transportation rates to ensure that LDCs are not implementing anti-competitive administrative charges; gas suppliers must work to improve their cost structures; and customers, especially those commercial and industrial users that operate in many jurisdictions, must exert political pressure.[68]

The Ontario Energy Board favours a "managed process" to foster gas market competition while protecting customers.[69] Other regulators are wary of "micromanaging" the transition to competition. In Massachusetts, regulators have adopted affiliate standards of conduct but have intentionally avoided making too many rules which they say could impede the development of competitive markets.[70]

The Ontario process saw a Task Force convened with industry, regulatory, and government involvement. The Task Force, perhaps only naturally, felt that this approach was superior to any other:

> It is the overall consensus of the Task Force (and its subcommittees) that its efforts undertaken to date have informed and benefited all constituents and have encouraged the development of working relationships that do not generally arise through more formal hearing, mediation or rule-making processes. While significant competing interests are "in play", there are the threads of a common vision for the future of the natural gas industry in Ontario. The desire to facilitate an orderly and effective transition to a more competitive and efficient, but equally reliable, market motivated all Task Force members to persevere, with open minds, when consensus proved elusive.[71]

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64 P. Bennett, "Consumer Choice in Natural Gas: A Hard Look at Savings" (1998) 136 *Public Utilities Fortnightly* 32. See also "High LDC Transportation Rates Limit Marketers From Competing" *The Energy Report* (24 August 1998), online: NEXIS (Energy, CURNWS).

65 "State Development: Oklahoma Corporation Commission Delays Gas Supplier Choice Program By More Than A Year And A Half" *Foster Natural Gas Report* (15 April 1999) 23, online: NEXIS (Energy, CURNWS). The delay was prompted by Oklahoma Natural Gas Co., an LDC, filing a lawsuit against the commission for exceeding its jurisdiction by directing the LDC to seek competitive bids for upstream services. See also *supra* note 44.

66 *Supra* note 44.

67 *Order* (5 January 1999) (Arizona Corporation Commission) (5 January 1999).

68 Bennett, *supra* note 64.

69 *Unbundling Report*, *supra* note 34.

70 "Industry Debates Depth Of Utility Restructuring" *Gas Daily* (14 September 1998), online: NEXIS (Energy, CURNWS).

71 *Supra* note 35 at 2.

The Task Force undertook a broad review of industry restructuring but, on the advice of the Ontario Energy Board and government representatives on the Task Force, did not address consumer protection issues such as those related to licensing, codes of conduct, customer contracts, dispute resolution, and policing and enforcement. The Task Force also did not consider the way in which restructuring of the gas industry would become compatible with electric industry restructuring nor did it address the anti-trust/competition issues.[72]

As alluded to in the quote above, the Task Force reached consensus on a few recommendations, made progress in a couple of areas, and failed to reach consensus on certain fundamental issues. As a result, the Task Force made recommendations in fourteen areas and proposed that its four subcommittees continue to work out the technical details flowing from those policy recommendations. This lack of consensus actually drove the content of one of the Task Force's assumptions: that LDC bundled services would remain available to consumers during a transition period due to the difficulty in achieving consensus on some of the issues.[73]

It is important to recognize that the Task Force favoured a "pull" approach to the process (making customer choice as attractive as possible to customers) rather than a "push" approach (forcing customers to choose an alternative supplier).[74] The Task Force suggested a timetable for the following elements of the unbundling process:

(1) customer awareness through billing inserts in February 1999;
(2) development of a bare-bones algorithm to simulate demand profiles and allocate capacity where daily metering for customers was unavailable by 31 March 1999;
(3) initial allocation of upstream transportation and storage capacity to end users as soon as possible;
(4) development of a wholesale rate for unbundled transportation and storage services for marketers dealing with daily nominations and delivery and imbalance settlements as soon as possible;
(5) expanded unbundling in wholesale service to marketers to include billing and collection by 1 January 2000; and
(6) further expanded unbundled service at a retail level to optionally include storage and billing collection not later than 1 April 2000.[75]

Whether regulatory and legislative reform is approached in carefully managed steps or in one big leap, it has been said that reform is inevitable.[76] Time will tell; this is particularly the case in those jurisdictions that have considered and rejected, at least for the time being, unbundling of retail natural gas services.

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72 *Ibid.* at 2-3.

73 *Ibid.* at 13.

74 *Ibid.* This is not the approach taken in all jurisdictions, of course. For example, Georgia has recently adopted the "push" approach, requiring customers who have not already done so to choose an alternative gas supplier within 100 days, *supra* note 48.

75 *Supra* note 35 at 8-9.

76 *Supra* note 2 at 149.

2. THE RELATIONSHIP BETWEEN THE LDC AND ITS MARKETING AFFILIATES

Regulators have always been sensitive to transactions between vertically integrated monopolies and their unregulated affiliates. The concern traditionally centred around the use of creative accounting to shift costs, risk, or profits between regulated entities and their affiliates. The end result was that customers would end up overpaying for services and bearing improper risks while providing the utility profits above the approved rate of return. In an unbundled environment, there are still issues with affiliate transactions as LDCs may be able to find ways to favour their affiliates while disadvantaging their competitors. In particular, there is concern that affiliates may gain an unfair advantage either through access to the LDC's technical staff and senior management, providing the affiliate with "inside" information on customers, or through the use of established LDC brand names and logos.[77] To address this sort of concern, legislators, regulators, and LDCs themselves[78] are establishing codes of conduct to govern the relationship between LDCs and their affiliates. The codes of conduct often draw from the FERC's *Order 497*,[79] which applies to interstate pipelines and their marketing affiliates, but often go into more detail about appropriate and inappropriate conduct. In particular, they often require LDCs to provide the same information, services, and pricing to all suppliers equally, whether affiliated or not. They also generally deal with restrictions on personnel sharing and the establishment of complaint procedures, reporting, and auditing. Energy analysts break the affiliate issue down into two parts: resource sharing and branding.[80]

a. Resource Sharing

The specific approaches to dealing with the sharing of resources vary from place to place. Pennsylvania's "Interim Code of Conduct"[81] is on the strict end of the spectrum, requiring complete separation of the LDC from its affiliates with no sharing of employees, no joint marketing, no dealing on inside information, and with comparable

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77 D.N. Jones, "Utility Marketing Affiliates: A Survey of Standards on Brand Leveraging and Codes of Conduct; No Clear Consensus Has Emerged. Should Regulators Hold To A Hard Line?" (1998) 136 *Public Utilities Fortnightly* 40.

78 Some LDCs quite rightly view the entry of competitors into the market as a way to increase the demand for gas and thus to expand their distribution systems. Unbundling also provides the LDCs with the opportunity to improve their image with their customers while halving their regulatory risk. See *GAO Study*, *supra* note 55. Cynical observers might prefer to think of the open-mindedness of these LDCs in initiating customer choice as being motivated by a desire to avoid having more stringent measures being applied to encourage competition; by taking the lead, they have the opportunity to direct how the inevitable will come about.

79 *Standards of Conduct for Interstate Pipelines with Marketing Affiliates*, 58 Fed. Reg. 22161 (1998) (F.E.R.C.) [hereinafter *Order 497*].

80 S. Hoffman, "Early Skirmishes Make News in the 'Affiliate Wars'" (12 April 1999), online: Power Online <wysiwyg://50/http://news.poweronline.com/steve/19990412-4832.htm> (date accessed: 19 May 1999).

81 Pennsylvania Public Utility Commission, *Policy Statement* (23 November 1996). Georgia has also placed fairly strict limitations on affiliate relations. *Natural Gas Competition and Deregulation Act*, Ga. Code § 46-4-150 (1997).

treatment for all suppliers. In spite of this hard line, independent suppliers "are complaining everywhere."[82]

Also at the stringent end of the spectrum is the state of Wisconsin. The Wisconsin Public Service Commission borrowed from *Order 497* to formulate its "Standards of Conduct."[83] Of note is the requirement for complete separation between the LDC and its marketing affiliates in order to prevent cost subsidization between the system and non-system gas sales performed by the LDC. Complete separation entails separate facilities for the utility and the marketing affiliate, including separate phone systems, support services, office supplies, furniture, and computer systems. The affiliate must be self-supporting and have its own personnel. The intention of this degree of separation is to prevent even the perception that the marketing affiliate would be accorded preferential treatment by the LDC and would in fact prevent the LDC and its affiliate from exercising undue market power. The Wisconsin Public Service Commission concluded that it would be impossible to assign upstream gas and capacity costs between the regulated and unregulated functions absent complete separation. Complete separation sacrifices any advantage of common capacity purchases and supply for an elimination of the risk of unfair market power.[84]

At the other end of the spectrum is Maryland. Its code of conduct[85] forbids only the sharing of high-level executives and takes the opposite view of the need for structural separation, reasoning that separation would remove efficiencies of scope. Abuses of affiliate relationships would be minimized or eliminated by other mechanisms, including performance-based rates to discourage transfer price inflation and a utilities commission complaints procedure that, upon successive violations, could force the divestiture of all interest in affiliates. Maryland's standards of conduct were developed in response to a petition by Baltimore Gas & Electric to create an unregulated marketing affiliate to be known as Baltimore Natural Gas. The Maryland Public Service Commission held that the two companies should be financially separate. These standards required that the services provided by the utility to its affiliate should be transacted at full cost, including both direct and indirect costs that could be clearly ascertained. Any services that could reasonably be marketed to the public and which have clear value to the affiliate should be allocated at the fair market value of those services. When transfers of assets occur, those transfers from the utility to the affiliate should be recorded at the greater of the book cost or the market value, whereas transfers in the other direction should be at the

82 *Supra* note 77.

83 *Re Investigation on the Commission's Own Motion Into the Need for Changes in Natural Gas Regulation for City Gas Company* (25 June 1998), 05-GI-108 (Wis. P.S.C.).

84 *Supra* note 12.

85 *Order No. 74038* (1998), 183 P.U.R. (4th) 277 (Md. P.S.C.). New Jersey is another state which places only loose restrictions on affiliate relations; it just requires accounting separation (*Order* (21 December 1995), GM-30-95 (N.J. B.P.U.)). The sentiment among New Jersey legislators and independent gas suppliers is that employee sharing has been damaging to the development of competition; the board may investigate this concern. *Supra* note 77.

lesser of the book cost or the market value.[86] Surprisingly, these arguably loose arrangements seem to have met with the satisfaction of competing suppliers.[87]

Taking the middle ground is Massachusetts. Its code of conduct[88] allows LDC affiliates to associate themselves with the LDC without representing themselves as the LDC itself. This code of conduct was developed through a collaborative process among interested parties, a process learned from the Ontario Energy Board.[89] Competing suppliers in Massachusetts are suspicious of the arrangements.[90]

Given the broad spectrum of approaches, it has been suggested that policymakers have not yet decided whether or not the separation of LDCs and their affiliates is necessary to protect competition. Professor Jones of the School of Public Policy and Management at Ohio State University believes that legislators and regulators should favour a strict approach while the market for competitive utility services is very immature. In particular, he advocates the following measures:

(1) Brand-sharing and staff-sharing between an LDC and its affiliates should be prohibited for a period of five years. When staff transfers do occur, they should be of limited duration: one-time events which are fully compensated to the LDC and flowed through to ratepayers.

(2) Regulators should remain alert to matters of cost-shifting. In particular, they should carefully scrutinize, through regular audits, the prudence and purpose of LDC advertising and prices paid to affiliates for services. Any dealings which provide an undue advantage to affiliates, including the sharing of insider information about customers, should be prohibited.

(3) An efficient and effective customer complaints procedure should be developed providing for the early involvement of the regulatory commission and notification to competition authorities. The frivolous complaints of competitors could be weeded out by establishing the complaints procedure as a user-pay system. Legitimate infractions should be punished through fines, divestment, and wide publicity.[91]

Lest anyone believe that codes of conduct may be ignored, one should be mindful that in November of 1998, Pacific Gas and Electric Company ("PG&E") was fined $1.68 million (United States currency) by the California Public Utility Commission for ninety breaches of that state's affiliate code of conduct.[92] PG&E had failed to include

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86 *Supra* note 12.

87 *Supra* note 77.

88 Massachusetts Department of Public Utilities, *D.P.U. 96-44* (December 1996). See also *D.P.U./D.T.E. 97-96* (1998), 186 P.U.R. (4th) 491 (Mass. D.T.E.).

89 See Part II.C.1, above, for a discussion of the Ontario Energy Board's unbundling process. Ontario's code of conduct is set out at *supra* note 33.

90 *Supra* note 77.

91 *Ibid.*

92 *Order* (5 November 1998) (Cal. P.U.C.).

legible disclaimers on its advertisements as clearly required under the affiliate rules. Further, it had failed to rectify the problem in later runs of the advertisements. The hefty fine broadcasts the commission's seriousness about enforcing its code of conduct.[93] This action should serve as a warning to LDCs that codes of conduct should be scrupulously adhered to; they are more than just idealistic statements of principle.

b. Branding

Branding has been a significant issue in the restructuring of the telephone industry, where new competitors of incumbent telephone companies argue that the use of telephone company brands on resold service[94] has the effect of foreclosing viable entry into the market. They are asking that regulators allow the competitors to place their own marks on the resold service — "rebranding" it — or at the very least, require that the incumbents remove their marks on the resold service — "unbranding" it. The issue of branding has presented a major obstacle in more than one-third of the approximately ninety arbitration decisions contained in the National Regulatory Research Institute's data bank, and some twenty-four state utilities commissions have, in the course of their arbitration and mediation activities under the *Telecommunications Act of 1996*,[95] had to deal with branding issues.[96]

In the natural gas industry, the issue has not been debated as hotly and brand name usage by the incumbent LDC is generally allowed. The Georgia Public Service Commission decided in July 1998 to prohibit an LDC from allowing its marketing affiliate to use a name "too similar" to its own for fear that it would be misleading and impede the development of competition.[97]

3. MARKET ENTRY

The ability of non-LDC gas suppliers to enter the market is of central importance in promoting competition, particularly as a competitive market develops. In that development stage, the incumbent LDCs initially control the whole market. Enabling competitors to gain market share requires the neutralization of the competitive advantages that the LDCs have, as well as the careful policing of the LDCs to ensure that they do not behave in an anti-competitive manner in trying to guard their control of the market (for themselves or for their marketing affiliates).

The issue is most pronounced in areas where the natural gas market is fully developed prior to the introduction of competition. For example, Ontario has a mature residential gas market; it has almost completely been converted to gas heating. With the

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93 *Supra* note 80.

94 Telephone services which are resold include operator and directory assistance services and direct customer contact services, such as installation and repairs.

95 Pub. L. No. 104-104, 110 Stat. 56 (1996).

96 *Supra* note 77.

97 *Ibid.*

exception of market creation through appliance replacement, especially in air conditioning, gas suppliers are fighting for their competitors' customers and not new ones.[98] In areas with immature markets, the biggest source of customers is the pre-conversion market, where new competitors may be on more of an equal footing with the LDCs.

An incumbent LDC may have any of the following significant competitive advantages during the initial stages of competition: access to customers, billing data, and other customer databases; monopoly control over the operation of the distribution system; name recognition and the natural reluctance of most customers to switch; familiarity with the regulatory commission; and rights-of-way.[99]

It is Professor Jones' contention that a lesson should be learned from telephone industry restructuring where, he says:

> public policy wildly underestimated the power (and will) of the incumbent utility to resist and frustrate change to its own advantage. Despite the rhetoric, it has gone rather badly and so far, at least, has mostly fizzled in the case of local service and residential and small business customers. Clearly, more must be done to constrain the incumbents if we are to rely on markets to produce a public interest outcome.[100]

In Canada, both consumer groups and non-LDC suppliers had complained that the incumbent LDCs were unfairly favoured in their role as both merchant and distributor. Particular examples of abuse of these two roles cited by consumers and suppliers include: unclear or misleading information in customers' bills, biased customer surveys, the absence of customer education programs, continued use of prohibited sales programs, control of gas purchase agreements that limited multi-year relations, and cross-subsidization of the merchant service by the distribution function. These concerns prompted provincial regulatory commissions to adopt rules requiring the separation of the merchant and distribution functions of the LDCs and enforcing rules governing affiliate transactions.[101] In several customer choice programs surveyed in the *GAO Study*, particularly in Pennsylvania and Ohio, LDC affiliates were characterized as having large market shares, an indicator that raised concerns among regulators that competition had been compromised somehow by the LDCs.[102]

Quite apart from the LDCs' competitive advantages and anti-competitive behaviour, are the barriers to entry which arise as a structural problem with the unbundling process. For example, inherent in the nature of pilot programs for supplier choice are limitations on duration and scope. One such limitation is on the number of customers allowed to participate in the pilot. This clearly affects the ability of certain customers to enter the competitive gas supply market and, by extension, places a limit on the

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98 *Supra* note 26.
99 *Supra* note 12.
100 *Supra* note 77 at 45.
101 *Supra* note 12.
102 *GAO Study*, *supra* note 55, cited in Hoffman, *supra* note 80.

number of suppliers that such a constrained market can bear.[103] Some pilot programs explicitly place limits on the number of suppliers that may participate; others mandate that a certain minimum number of competitive suppliers must decide to participate before the pilot is permitted to proceed.[104] The *GAO Study* found that more than one-third of the LDCs reporting residential customer choice programs had restricted customer eligibility to fewer than one-half of their residential customers.[105]

Whether in a pilot program or otherwise, regulators need to be concerned with the ability of gas suppliers to meet their obligations to their customers. A requirement is often imposed that gas suppliers must qualify for participation in the market.[106] An alternative measure which has been suggested is that suppliers post a performance bond.[107] In either case, there is a risk that these measures may be stricter than they need to be and may act as a barrier to entry. It is important that the proper balance be struck between protecting customers and encouraging competition.

4. STRANDED COSTS

"Stranded costs" are those transitional costs that LDCs are faced with at the outset of unbundling and retail competition for which no prior cost recovery mechanism is in place. They relate primarily to contracts for upstream transportation capacity and storage, as well as to capacity on their own systems which will go under-utilized as competitors use their own contracts for transportation and storage. The issue tends to be more significant where, as in parts of the United States, there are many different transportation and storage alternatives for delivery to a particular market area.

While stranded costs were the biggest issue at the interstate level when the FERC stimulated competition through *Order 636*,[108] it is likely that the magnitude of stranded costs for LDCs may be far less significant for several reasons. First, LDCs have replaced many of their long-term contracts with short-term contracts for pipeline and storage capacity. Secondly, the development of a robust market for reselling excess

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103 Central Illinois Light Co. capped participation in its customer choice program at just 10,000 customers, or 6 percent of its customer base. Only one alternative supplier ended up serving the program. See *GAO Study*, *supra* note 55.

104 For example, Colorado introduced a bill to unbundle the gas market at the retail level with a key required element that there was to be at least five gas suppliers in a service area to promote competition. The bill also allowed the recovery of transition costs by LDCs and contained a direction to the Colorado Public Utilities Commission to study the effects of market restructuring on low-income consumers, H.B. 98-1400, Colorado 1998. A committee of the state legislature voted to indefinitely postpone any action on the bill last spring, bringing natural gas deregulation in Colorado to a halt. See *Foster Natural Gas Report*, *supra* note 42.

105 *Supra* note 55. For example, Baltimore Gas & Electric had capped participation in its program at just 9 percent of its residential customers.

106 For example, in Wyoming, Questar Gas Company's approved supplier choice program for residential and commercial customers requires that gas suppliers meet specified qualifications in order to participate, *supra* note 44. Montana Power Co. has made a proposal for a pilot program which requires that alternative suppliers provide proof of their creditworthiness and secure a minimum aggregate load of 5,000 decatherms per year, *Foster Natural Gas Report*, *supra* note 42.

107 *Supra* note 2 at 161.

108 *Supra* note 10.

capacity may help LDCs mitigate any stranded costs. Thirdly, in some instances, LDCs have included *force majeure* clauses or operational displacement provisions that enable them to reduce their purchases in the event that customers switch to alternative suppliers.[109]

The responsibility for stranded costs will of necessity fall to LDCs, their competitors, consumers, or to any combination of them. LDCs are likely to argue that they be allowed to recover costs that were prudently incurred to meet their obligation to provide reliable service. Opponents of this position may argue that it is inappropriate to insulate a firm in a competitive industry from the normal risks of doing business, as has been argued in the electric utility industry. The argument is that to allow an LDC to recover these costs would delay competition and deny benefits of the competitive market to customers of the LDC. Furthermore, complete recovery of stranded costs would not provide incentives for the LDC to mitigate those costs. A "middle-ground" approach, and one which has not gained wide acceptance, would be that the LDC should absorb some of the costs to induce efficiency and to mitigate concerns that the LDC would try to inflate such stranded costs.[110]

The recovery of prudently incurred costs from customers appears to be the rule. The New York Public Service Commission allows LDCs to recover prudent net stranded capacity costs from firm sales and post-aggregation firm transportation customers.[111] In Ontario, the Task Force stated that fairness requires that all users should contribute to the LDC's stranded costs over a reasonable time period, provided that the LDCs vigorously mitigate those stranded asset costs.[112]

There are several ways in which upstream transportation and storage capacity costs may be passed on. LDCs may require suppliers to take capacity on the interstate pipelines through capacity release contracts. Alternatively, the LDCs may assign the capacity and associated costs directly to the suppliers' customers. Still another way to pass on firm capacity costs is for an LDC to impose a transition surcharge directly on its customers.[113]

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109 *Supra* note 12. It appears that an LDC will be entitled to avail itself of operational displacement provisions even where the displaced customer volumes have gone to the marketing affiliate of the LDC. A successful argument would have to be made for the piercing of the corporate veil between the LDC and its affiliate in order to prevent this outcome.

110 *Ibid.*

111 *Order* (16 March 1999), 98-G-185 (N.Y. P.S.C.).

112 *Supra* note 35. It was recommended that entitlement to capacity for storage and upstream transportation to end users be optional, as opposed to mandatory, and that there should be provision for LDCs to recover stranded costs after mitigation. The Task Force recommended that each LDC rely on a guiding principle of equal proportional access in the allocation methodology to be employed. The Task Force preferred a market-based pricing mechanism to allocate storage capacity but was unable to devise an appropriate mechanism and instead proposed tying storage capacity to the customer during any transitional period on the basis of cost-based storage prices. With respect to upstream transportation, a one-time optional proportional allocation was recommended.

113 "High LDC Transportation Rates Limit Marketers from Competing" *The Energy Report* (24 August 1998), online: NEXIS (Energy, CURNWS).

Steven E. Winberg, Director, Energy Policy of Consolidated Natural Gas Company, believes that the opportunities for customer savings will be slim in the transition period while stranded costs are being recovered:

> It's pretty clear to me that we are going to see a transition period in just about all the states.... That transition period usually deals with overcoming stranded or transition costs. For gas, it's the capacity contracts that need to expire. To the extent that LDCs are held harmless for those contracts, we're looking at a perhaps three- to five- year period where they will be transitioning. And it's during this transition period that there may not be a whole lot of savings for customers.
>
> Once we get beyond the transition period and LDCs are no longer in the long-term market for capacity – they're either not buying as much or buying on a shorter-term basis – I think that's where there will be opportunities for savings.[114]

5. CONSUMER PROTECTION AND EDUCATION

The *GAO Study*[115] found that customer education was a factor which increased participation in supplier choice programs across the United States. For example, Massachusetts' Bay State Gas achieved a participation rate of 28 percent, considered to be "high" participation in the study, through an extensive customer education program involving direct mail, billing inserts, newspaper, radio and television advertisements, and the efforts of suppliers. The education program was managed collaboratively with state regulators, consumer groups, and gas suppliers.[116]

Irwin A. Popowsky, President of the National Association of State Utility Consumer Advocates, discussed consumer education with *Fortnightly*:

> People ought to be able to have the same information about how much the price is per kilowatt-hour, or the price per [thousand cubic feet of gas]. Uniform price disclosure doesn't mean uniform pricing, but you need to have some uniform disclosure so that people can make a reasonable choice without having to read a 50-page gas tariff.
>
> Multiple parties are responsible for educating consumers. Certainly the various participants in the market are going to try to tell people what their products are; that's a form of education, but the truth is that's primarily marketing.
>
> There is a government role to let people know what the basic rules are. Pennsylvania established a hotline to answer questions and they've received thousands of calls about the electric pilots. Our office has put out a brochure and met with a lot of consumers. I think people need to be able to call somebody who has no particular financial state in whom you buy from.[117]

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114 L.M. Rodgers, "Mapping the Universe of Natural Gas; Closed, Shrinking or Expanding?", online: Public Utilities Reports Inc. <http://www.pur.com/g_forum.htm> (date accessed: 27 April 1999).

115 *Supra* note 55.

116 *Gas Daily*, *supra* note 55.

117 *Supra* note 114.

Aside from explaining developments in the natural gas industry and their choices to customers, consumer education is one part of consumer protection. The high degree of competition, which has been characterized by "suitcase brokers" and supper-time marketing calls, demands that consumers be protected beyond education alone.

One major LDC in Ontario has claimed that, while almost one million customers have turned to alternative energy suppliers, many of those customers are not even aware that they have switched due to the use of "tricks" and "confusing tactics" by those suppliers.[118] In response to such concerns, the Ontario Energy Board promulgated its "*Marketer Code*"[119] (which came into force on 2 March 1999) as a rule made under the *Ontario Energy Board Act.*[120] Unlike other "codes of conduct" discussed above which deal with LDC-affiliate relationships, the *Marketer Code* sets out consumer protection rules for gas marketing activities aimed at "low-volume consumers." Under s. 1.1 of the *Marketer Code*, a low-volume consumer is "a person who annually uses less than 50,000 cubic metres of gas," and is thus not limited to residential users (nor may it cover large-volume residential users) or even to natural persons. The *Marketer Code* contains the following provisions:

(1) *Fair Marketing Practices.* A marketer is required to identify itself promptly and clearly, not to exert undue pressure or harass a consumer, not to make misleading representations or any oral representations not contained in a written offer, to provide accurate comparisons, and to ensure the accuracy and readability of promotional materials. The marketer may only ask the LDC to switch a consumer from its current supplier with the consumer's permission in writing. These provisions do not oust the application of other consumer protection or competition legislation.

(2) *Identification.* A marketer is required to identify itself by the name under which it is licensed and, when marketing at a place other than its own premises, to provide detailed identification of itself and its salesperson.

118 *Supra* note 57.

119 *Supra* note 37. For insight into the development of the *Marketer Code*, see Ontario Energy Board, *Advisory Report on Licence Requirements for the Marketing of Natural Gas and Electricity to Residential and Small Commercial Consumers* (6 October 1998), online: Ontario Energy Board <http://www.oeb.gov.on.ca:80/decision.htm> (date accessed 20 May 1999). While the Task Force did not formally address consumer protection and education issues in its report, it did make a number of recommendations in those areas, most of which appear in the *Marketer Code*. The Task Force advocated a consumer education campaign to be conducted through billing inserts and complemented by website postings, community newspapers, and call centres. It was the Task Force's view that the Ontario Energy Board and the government should be seen to stand behind this consumer awareness campaign. Furthermore, the Task Force recommended that specific customer data and information should only be disclosed with the customer's consent and advocated that there be electronic access to the list of licensed marketers for LDCs and others. *Supra* note 35.

120 *Supra* note 61.

(3) *Information to be Maintained by a Gas Marketer.* A marketer must keep a list of its salespersons, a list of its customers together with written permission for the LDC to switch the customer, and a gas purchase agreement for each.

(4) *Confidentiality of Consumer Information.* Disclosure of consumer information without permission is forbidden except for billing matters and legal compliance unless it has been aggregated so that individual information is unidentifiable.

(5) *Conditions in Offers.* Marketers must provide clear information about the terms and conditions of an offer, including time for acceptance, start date, renewal conditions, fees and charges, type and frequency of bills, complaints resolution, rescission, termination, and assignment. A copy of the contract must be given to the consumer upon execution.

(6) *Contracts.* Contracts must match offers, are limited to terms of five years or less, and may be rescinded within ten days by the consumer.

(7) *Contract Renewals.* A consumer must be given ample advance notice of a contract renewal and the right to cancel any renewal. A renewal must be upon the same terms unless otherwise agreed in writing by the consumer; however, this is not the case when the renewal is for less than a year, although any price change must be disclosed to the consumer in the renewal notice.

(8) *Assignment, Sale, and Transfer of Contracts.* Marketers may only assign to other licensed marketers and the consumer must be notified within thirty days of the assignment.

(9) *Independent, Arm's-Length Consumer Complaints Resolution Process.* Marketers must inform consumers about their complaints resolution process and must investigate and attempt to resolve complaints prior to referring them to the resolution process.

Section 2.10 of the *Marketer Code* provides that a breach may be redressed with the suspension or loss of the marketer's licence, which effectively puts a stop to all marketing activities for the duration of the suspension or loss. The use of licensing to control gas suppliers is relatively common but is not without controversy. In Wisconsin, the licensing of marketers under a proposal for registration and certification for residential marketers is to be carried out by the LDC; needless to say, gas suppliers do not favour the LDC having this power as it seems to facilitate its abuse by the LDC.[121]

6. OBLIGATION TO SERVE AND RELIABILITY

Most public utility laws contain the concept of an "obligation to serve." This is seen as the *quid pro quo* for the grant of a monopoly franchise and recognizes the public

[121] *Foster Natural Gas Report, supra* note 42.

interest in maintaining reliable service. When competitive services are unbundled from monopoly services, the obligation to serve may attach differently to each of them. Monopoly services should continue to be subject to the obligation to serve, but, in those functions where the LDC is just one of many service providers, the obligation to serve should be lifted. Nevertheless, there are certain situations for which an obligation to serve is being debated in spite of the competitive nature of the service: gas supply to customers with poor credit, gas supply in emergencies, and back-up gas supply to maintain system integrity. It has been suggested by Costello & Lemon that the first situation is one that should be dealt with through social policy and not with an obligation to serve. The other two may properly be dealt with through the requirement of an obligation to serve.[122]

In Ontario, it has been recommended that suppliers should have an obligation to serve any customer in their chosen market segment, provided that they also have the ability to stipulate the terms of service upon which they would serve those customers. However, it was also recommended that marketers should have the right to terminate service for non-payment pursuant to their supply agreements, subject to "shut-off" standards that would be approved by the Ontario Energy Board, including mandatory service for existing residential heating customers in situations where public policy concerns would be raised (*e.g.* considerations of winter weather, health, or other social issues). Funding for mandatory service would come from a set gas commodity charge which would be collected from all distribution system users and would reimburse suppliers and LDCs for the value of gas supplied. The Task Force could not agree on whether shut-off could be invoked to recover distribution costs. It was recommended that the LDCs maintain control over shutting off customers.[123]

What happens when suppliers fail to meet their obligation to serve? Steven E. Winberg of Consolidated Natural Gas Company envisions the role of "supplier of last resort" ("SOLR") as a function that is tendered on a competitive basis rather than falling to the LDCs to perform as part of an obligation to serve. He sees the LDCs being in very close communication with suppliers on their systems; if a supplier defaults, the LDC would go to the SOLR to supply the shortfall and the SOLR would pursue the defaulting supplier. The SOLR would probably have close ties with the regulator, but need not be the LDC.[124]

On the question of system integrity, the Ontario Task Force recommended that a variety of load balancing services be made available by LDCs to customers in keeping with a desire to maximize choice and flexibility. The Task Force posited a three-tiered load balancing service which, at the basic level, would provide basic load balancing as part of the normal delivery rate, a "user pay" second tier which would allow for special

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122 *Supra* note 2 at 161-63.

123 *Supra* note 35.

124 *Supra* note 114. This is not the case in Washington, D.C., for example, where Washington Gas Light Co. retains the obligation to serve customers under its pilot program if a supplier defaults. *Foster Natural Gas Report*, *supra* note 42.

peaking or other services, and a third tier aimed at deterring supplier performance defaults through an incentive rate structure.[125]

As competition increases, there will be a temptation for suppliers to reduce costs at the expense of reliability, for example, by relying more on interruptible capacity as a substitute for firm capacity.[126] This issue may be approached from two perspectives: either put mechanisms in place to prevent this activity or allow reliability to be one factor of the service negotiated by customers. To ensure reliability, the California Public Utility Commission, in its CAT program, ranked core customers above non-core customers served by the LDC in the event of curtailment. The LDCs were allowed to charge a prohibitive ten dollars per decatherm charge for back-up service; however, alternative suppliers were allowed to mitigate this potential cost by trading positive and negative imbalances among themselves. With respect to obligation to serve, the California Public Utility Commission has taken the position that it is up to customers and not the LDC to determine the quality and level of service that best meet their needs.[127] The Ontario Energy Board did not initially exercise strict oversight of the alternative suppliers to ensure reliable service. Its position was that this was one aspect of the customer's decision and that the customer should accept the risks of making that decision.[128] The Task Force's recommendations are generally in line with that sentiment, relying as they do on contractual terms between customers and suppliers.

Another aspect of reliability is gas supply planning. Prior to unbundling, the LDCs were responsible for gas supply planning. That function will now have to be fulfilled by the competitive suppliers. Section 303(b)(3) of the *Public Utility Regulatory Policies Act of 1978*[129] required state utilities commissions to consider whether it was appropriate for gas utilities to be required to undertake integrated resource planning ("IRP"), a form of gas supply planning, and to adopt demand-side management ("DSM"), generally regarded as including conservation (reducing the amount of gas used), direct control (usually aimed at reducing the peak demand), and rate design (such as interruptible rates and real-time pricing). Some state utilities commissions did require LDCs to conduct IRP.[130] Other states, such as Illinois and Arizona, have either declined or not acted on this issue. In those states, many LDCs have their own integrated planning processes for their system in spite of the lack of state imposed standards. Again, as with IRP, some state commissions ordered utilities to undertake DSM programs, at least on an experimental basis, to determine the value of DSM. In

125 *Supra* note 35.

126 *Supra* note 12.

127 *Supra* note 25.

128 *Supra* note 12.

129 16 U.S.C. § 2601 *et seq.*

130 *IRP Rules* (December 1992), D-92-12-058 (Cal. P.U.C.); *DPUC Investigation Pursuant to the National Energy Policy Act of 1992* (22 October 1993), 93-03-17 (Conn. D.P.U.C.); *Commission Order* (1993), 3731 (Del. P.S.C.); *Re the Consideration of the federal gas utility rate-making standard dealing with integrated resource planning* (January 1994), 25342 (Idaho P.U.C.); *Commission Order* (1995), U-10589 (Mich. P.S.C.); *Order* (1993), G-999/C1-93-895 (Minn. P.U.C.); *Order* (11 January 1996), G-92 sub 66 (N.C. U.C.); *Commission Order* (1995), 05-G1-107 (Wisc. P.S.C.).

a competitive market, unless mandated otherwise by regulators, it seems likely that IRP and DSM will be undertaken by customers and suppliers when it is cost effective for them to do so.[131]

7. CUSTOMER MOBILITY

Obverse of the obligation to serve on the part of the LDCs and suppliers is mobility on the part of customers — the ability of customers to switch suppliers with little administration. High customer mobility seems to be a goal of competition in the long run. However, the short-term transitional period tends to be characterized by low customer mobility.

In Ontario, the Task Force agreed on four objectives for customer mobility but could not reach agreement on how to reach those objectives, asking the Ontario Energy Board to direct a resolution of the issues. These objectives were:

(1) that customer mobility should be facilitated and is essential to effective competition;

(2) that "full" mobility (*i.e.*, suppliers solely having resort to normal contractual remedies) should be in effect as soon as practicable;

(3) that LDCs will remove themselves from the middle of the end-user and supplier relationship as soon as practicable; and

(4) that any mechanism to facilitate customer mobility should be designed to avoid anti-competitive barriers and to ensure an adequate level of customer protection and education.[132]

Currently, a natural gas consumer in Ontario wanting to switch gas suppliers can wait for ten weeks due to the officious paper trail under present rules. Meanwhile, a switch of long-distance telephone suppliers can be achieved in one week.[133] Pilot programs in the United States generally limit customer mobility. For example, in 1998, the Wyoming Public Service Commission approved a service option for Questar Gas Company's residential and commercial customers to buy gas from alternative gas suppliers. The plan involves an open season for customers every March. Customers who chose to switch to an alternative supplier may switch to yet another supplier other than the LDC during the year. Customers wishing to return to the LDC must wait until the following open season. This is aimed at keeping the LDC's prices down by allowing it to purchase its gas supplies in advance of the heating season and not to have to purchase expensive gas during the heating season to serve returning customers.[134] This program provides no protection for the alternative suppliers against customer

131 *Supra* note 12.
132 *Supra* note 35 at 5.
133 *Supra* note 26.
134 *Supra* note 44.

defections; as a result, they will be forced to rely more heavily on spot purchases than will the LDC.

8. PRICING

The appropriate pricing rule for an unbundled service offered by an LDC depends on the nature of the service. Those services with monopoly features will continue to require regulatory control to some degree. Pricing options for such services include performance-based (incentive) regulation, fixed-variable or volumetric rates, embedded-cost pricing, and negotiated pricing. The unbundled distribution service is one such service to which these comments would apply. Competitive services, on the other hand, such as gas supply, where market forces would prevent the LDC from over-pricing those services for any sustained period, should not be subjected to any regulatory control. The market should be relied upon to control those prices.[135]

Traditionally, LDCs have been subject to cost-of-service price regulation for all services. Competition between incumbent LDCs and alternative suppliers of natural gas may make appropriate other forms of regulation for the remaining monopoly-like services. In particular, performance-based rates are being recommended, primarily as a transitional mechanism, to emulate a competitive market and to enable smaller customers to reap some of the benefits of the competitive gas market. Performance-based rates are intended to provide an incentive to the LDC to reduce its costs by allowing the LDC to retain some portion of the savings it achieves. On the other hand, if an LDC fails to meet the cost level targets prescribed by the performance-based rates, the LDC and its investors become liable for some portion of the difference. The problem with cost-of-service rates is that utilities may be rewarded more for justifying costs than for controlling them. Performance-based rates are intended to separate costs from rates. Many states, including California, Colorado, Connecticut, Minnesota, and Maine, have approved performance-based rates.[136]

In 1998, the issue of LDCs providing a fixed-price option to their customers for distribution services arose in New York and Indiana. This is a form of price protection for customers which, in the former case, was mandated by the regulator and, in the latter case, was proposed by an LDC.[137]

9. THE NEW ROLE OF THE REGULATOR AND COMPETITION LAWS

It should be noted in passing that in a competitive market, competition and anti-trust laws have a role to play. It has been said that "[j]ust as regulation provided the basic competitive rules for the natural gas industry for many years, in its wake the core order

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[135] *Supra* note 2 at 150.

[136] *Supra* note 12.

[137] *Foster Natural Gas Report, supra* note 42.

will be provided by anti-trust laws...."[138] Assigning the proper roles for regulation and competition requires recognition of the following issues:

(1) the characteristics of the industry that creates the need for regulation;

(2) the restriction of regulation to the sectors or transactions in which market forces cannot possibly operate;

(3) the ability of the regulator to approve or set rates or terms and conditions for transactions that would be most similar to the ones that competition would create in a well functioning market; and

(4) a determination of the interface of anti-trust laws and regulation in the industry.[139]

Nowhere has the removal of all regulatory intervention, whether based in utilities law or competition law, in the competitive gas market been advocated. Regulators need to remain sensitive to market imperfections and the possession of market power. They need to oversee profit levels and market shares to determine whether companies are successfully discriminating, tying products, and charging monopoly prices. Without the ability to set rates, regulators need a framework to enable them to determine whether abuses are occurring.[140] Where the dividing line lies between utility regulation and competition and anti-trust laws will vary from place to place. The Ohio Public Utilities Commission has expressly stated that its approval of contracts between LDCs and their affiliates do not constitute "state action" which would insulate the parties from anti-trust laws.[141] Likewise, the Ontario *Marketer Code* is quite clear that competition laws continue to govern gas suppliers.[142]

In whatever way the roles of utility regulation and competition law may be split, according to Costello & Lemon:

> for service unbundling to be economical it must function in a market and regulatory environment where efficiency and consumer responsiveness determine the success of different service providers. Outcomes induced by regulatory and market malfunctions violate this condition. These malfunctions may include entry barriers, rigid regulatory-pricing and obligation-to-serve rules, and discriminatory access to natural-monopoly facilities. Any of these could induce inefficient performance of the natural gas industry.[143]

As well as the interface with competition and anti-trust laws, natural gas regulators at the provincial and state level must recognize an interface with natural gas regulators

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138 J.B. McArthur, "Anti-Trust in the New Deregulated Natural Gas Industry" (1997) 18 Energy L.J. 1 at 38.

139 *Supra* note 16 at 119-20.

140 *Supra* note 138 at 49-58.

141 *Supra* note 12. See also *supra* note 77.

142 *Supra* note 37, s. 2.1.

143 *Supra* note 2 at 148.

at the federal level. The FERC has recently concerned itself with the status of state unbundling activities. It held a conference on 25 February 1999 to hear different views on how to coordinate federal and state regulation to facilitate competition in the natural gas industry.[144] In particular, the FERC was interested in knowing how state programs deal with upstream capacity release and with the FERC's "shipper must have title" policy which it has waived on a case-by-case basis for unbundling LDCs. Industry leaders told the FERC that the waivers of the policy should continue, albeit for longer terms than the current one-year maximum, in order to improve certainty.[145] Many participants advocated the repeal of the policy, but the FERC views this policy as an important part of *Order 636*[146] which it does not wish to compromise. A clear concern of state commissions was the "hoarding" of upstream capacity by large energy marketers, as LDCs shed it through the unbundling process, with the effect of significantly increasing basis differentials and undermining the price reductions sought from the process. This sort of regulatory coordination is a good thing; while the jurisdictional boundaries are clear, there is no denying the impact that federal action may have on state matters and *vice versa*.

10. SERVICE INNOVATIONS

What, on one hand, is a period of turmoil in the natural gas industry is, on the other hand, a time of opportunity for creative enterprises. It has been observed that:

> [b]arriers to entry are relatively low, which explains why over 1,000 companies, most of which are very small, call themselves gas marketers. Also, natural gas supplies are relatively abundant. Service offerings are remarkably homogeneous. Until the industry learns how to compete on some basis other than price, the bulk of any improved savings that arise from rate reform will go to customers in the form of greater savings, not suppliers.
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> Accordingly, marketers must become far more efficient in transacting their business. Processes and systems — billing, customer care, customer acquisition and volume management — are uniformly weak. Data from transactions are frequently entered multiple times. Sales processes and relationships with customers are rarely institutionalized as the industry continues to use relationship based sales techniques that are common among wholesale marketers. Marketers must invest in new business practices and the associated systems so that they can improve their own margins and competitive positions. Again, until tariff rate reform proceeds, the needed investments cannot be sustained. Profit margins are simply too low.[147]

To increase their competitiveness in the unbundled market, LDCs have begun to partner with marketing specialists and asset managers. An asset manager takes control of the hardware and contracts of the LDC and its biggest customers and makes them

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144 "Commission Conference On 2/25/99 Will Focus On Interaction Of Federal Regulation Of Interstate Pipelines And Efforts Of The States To Unbundle Retail Gas Services; FERC Also Will Convene Broad Conference On Short-term Gas Transportation Issues Early Next Year" *Foster Natural Gas Report* (29 October 1998), online: NEXIS (Energy, CURNWS).

145 *Supra* note 46.

146 *Supra* note 10.

147 Bennett, *supra* note 64.

operate more efficiently, thus enabling it to offer guaranteed demand charge savings to its clients. There are further opportunities for asset managers as industrial customers take release of pipeline capacity from their LDCs and would otherwise have to employ staff to nominate for and monitor their supply needs. It is also likely that gas merchants entering the market following deregulation will take advantage of the services offered by asset managers. As discussed above, with gas supply customers turning to other merchants, LDCs may be left holding long-term gas supply contracts for greater volumes than their remaining customers can use. An asset manager removes that problem by taking over the contracts and an LDC's supply obligations. This mitigates the risk of stranded costs and improves customer retention by the LDC. These companies specialize in wholesale energy asset optimization, including the economic and efficient utilization of transmission and storage capacity; essentially, they are recreating the role of the pipelines prior to *Order 636* unbundling. By reconstituting the economies of scale which have been fragmented during the unbundling process, asset managers are able to compete successfully.[148]

Opportunities also abound for information technology suppliers as LDCs find themselves handling more information.[149]

According to Vinod K. Dar, former Managing Director of Hagler Bailly Consultants, in the first generation of competition, while competitors offer homogeneous services to customers, the only room for generating savings for customers is by shaving the margin on the sale – right to the point of selling at cost. It is the second generation of competition where the opportunities for customer savings, and supplier profits, arise. This period is characterized by innovation and the creation of customized offerings.[150]

In Ontario, non-LDC gas merchants are well placed to capture even more than the 40 percent of the residential market they already serve; however, the big players have recognized that the strong competition for this market and the trend to shave ever

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148 "Era Of Big Market Specialists Unfolds As Outfits Seek Their Competitive Edge" *The Energy Report* (27 April 1998), online: NEXIS (Energy, CURNWS). For example, KeySpan Energy Corp. and Enron Capital & Trade Resources Corp. ("Enron") announced in May 1998 that they had formed a strategic alliance to market gas supply management services to LDCs in the northeastern United States. By integrating an LDC's transportation, supply, and storage assets with Enron's gas trading and risk management business, the alliance expects to improve the LDC's profitability. Also in May 1998, an Enron subsidiary announced the formation of a strategic alliance with CB Richard Ellis, a commercial real estate services firm, to provide energy services to its commercial and industrial property clients. See "KeySpan and Enron Form Alliance To Market Gas Supply Management Services; Enron Also Allies With Real Estate Services Firm To Provide Energy Services" *Foster Natural Gas Report* (28 May 1998) 28, online: NEXIS (Energy, CURNWS).

149 For example, Southern California Gas Co., the largest LDC in the United States, and TransEnergy Management Inc., an energy marketing software company, have joined together to develop and market to LDCs a software product which performs a wide range of functions from contract administration to billing and which is specifically aimed at managing services for increased numbers of transportation customers behind the LDC city gate. "Unbundling Leads to Partnership; TransEnergy Management Inc., Southern California Gas Co. Develop Energy Distribution Automation Software Called LDC Manager" (1998) 225 Pipeline & Gas J. 61, online: NEXIS (Energy, CURNWS).

150 *Supra* note 114 at 13-14.

smaller margins off growing volumes means that the real opportunity to make money lies elsewhere — in the post-competitive world of "convergence." Convergence is the moniker used to describe the bundling of formerly disparate consumer services, including such things as natural gas, electricity, local and long distance telephone, cell phone, internet, cable, home security, and even garbage collection and recycling. Strategic alliances will be formed between the various service providers with the benefits of sharing the lower fixed costs of a single marketing group and the ability to stick to the business they know while participating in a new consumer offering. For the consumers, convergence will provide one-stop shopping for services, the simplicity of a single bill instead of many, and the possibility of sharing in the savings due to lower fixed costs. Brand names will be of great significance in a converged marketing group; Bell Canada will probably prefer to partner with the solid reputation of Sunoco rather than Joe's Gas Sales.[151]

The possibilities for innovation are virtually limitless and have been unleashed by competition in the market. While this article has portrayed many of the challenges that unbundling and competition presents, it should be remembered that challenges are opportunities in disguise.

D. AN UNBUNDLING REPORT CARD

There are some common themes to what various parties claim as their goals of unbundling. The Wisconsin Public Service Commission was guided by the principle that increased customer choice should be one of the benefits of competition. Furthermore, it felt that gas utilities should have an opportunity to recover prudently incurred, verifiable, material stranded costs while maintaining safe and reliable service.[152] The Massachusetts Department of Public Utilities felt that competition could be ensured through the existence of many buyers and sellers with effective access to each other, arm's-length transactions between buyers and sellers, broad and equal access to timely information, low thresholds for entry into the retail gas market, and most importantly, no market participant or group of participants in a position to exert unfair or abusive market power in a competitive industry structure.[153] The California Public Utility Commission, through its CAT program, felt that the goals of any residential unbundling program were to (1) promote efficient use of the gas system; (2) provide core customers with service options; (3) ensure that core customers continue to receive the level of service that they desire, be that high or low quality; and (4) ensure a fair allocation of costs between customers and between customer classes.[154] Another LDC's view of the ingredients of successful deregulation includes:

(1) safe, reliable service for commercial and residential customers;
(2) a smooth transition to a competitive environment;
(3) full recovery of stranded costs by LDCs;

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151 *Supra* note 26.
152 *Supra* note 12.
153 *Ibid.*
154 *Supra* note 25.

(4) competition by LDC affiliates;
(5) a means to address social and environmental issues; and
(6) assured service for low-income customers, particularly in extreme temperature conditions.[155]

The one item missing from each of these laundry lists, and arguably the one which counts the most, is the ability of residential customers to save money on their gas bills.

> The success of unbundling is a matter of customer economics, not political pronouncements. Regulators and legislators can mandate open access, utilities can create unbundled tariffs, but if the customers cannot save money or non-regulated marketers cannot profit by selling either the commodity or new services, unbundling will proceed very slowly.
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> ...
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> Until rates are reformed to eliminate artificial impediments such as excessive administrative charges and allow for (even encourage) creative reconfigurations of the transportation and supply functions, marketers and others have little incentive to sustain their investments in the retail business.[156]

The likely reason that customer savings do not make the lists cited above is that meaningful savings have thus far proved elusive in the residential market of most jurisdictions, Ontario being a notable exception. In spite of the growing availability of supplier choice, customers have largely remained with their LDCs. For example, in New York, where supplier choice has been available since 1996, a mere 0.3 percent of residential customers and 7 percent of commercial customers had opted to purchase their gas from suppliers other than their LDCs after two years. Likewise in California, New Jersey and, until recently, Pennsylvania, supply choice programs have developed slowly. The reason for this is a lack of incentives for customers to make a change due to the limited potential to save money by purchasing gas from non-LDC suppliers.[157] The *GAO Study* determined that price competitiveness was the leading factor in influencing customers to switch gas suppliers.[158] To be fair, it has been reported that the California experience was that most core customers served by alternative suppliers recognized some savings compared to continued service from their LDC.[159] Certainly, in New York, oil is priced very competitively with natural gas so new suppliers may be competing as much with alternative fuels as with incumbent LDCs.[160] It is unlikely, however, that fuel switching is a significant factor at the residential level.

While it is a fact that only a small number of customers have opted to switch to a non-LDC supplier in Brooklyn,[161] Craig G. Matthews, President of KeySpan Energy

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155 *Supra* note 70.
156 Bennett, *supra* note 64.
157 *Ibid.*
158 *Supra* note 55.
159 *Supra* note 25.
160 *The Energy Report*, *supra* note 148.
161 *Supra* note 70.

(formerly The Brooklyn Union Gas Company), claims that New York LDCs are at a competitive disadvantage due to the application of state taxes:

> In New York state, utilities pay more taxes by far than the marketers, and we've been pushing very hard to have those taxes eliminated so we have the same playing field. The primary reason that marketers can save customers in the commercial sector a little bit more is because there's a sales tax that they don't pay, as well as gross receipts tax.[162]

Furthermore, he says, just providing LDC customers with a choice, whether or not they exercise it, will result in improved service from the LDC.

Taxes are an issue, but so is the practice of LDCs of forcing gas suppliers to take release of upstream transportation and storage capacity, as do eleven of thirty-eight LDCs surveyed in the *GAO Study*.[163] This practice could be impeding market participation and lowering potential savings by consumers; gas marketers often have access to a varied portfolio of upstream capacity alternatives that would be cheaper than taking release of the LDC's contracts.[164] As of 1 April 1999, New York LDCs were required to stop assigning upstream capacity to customers who switch to distribution-only service.[165] It will be interesting to see what effect this move will have on participation rates.

In a study conducted in 1998[166] which analyzed 100 LDCs, just 18 percent of those LDCs had tariff rate structures that permitted residential customers to save any money by switching suppliers. Only 5 percent allowed those customers to save more than 10 percent on their total gas bill. With respect to commercial customers, about 36 percent of the LDCs' rates allowed for any savings and 25 percent permitted savings of more than 10 percent. Industrial customers had the best opportunities for saving with values of 72 percent and 50 percent, respectively, for the two measures cited. The *BENTEK Study* concluded that the impediments to savings varied by LDC and customer class. However, it could generally be said that for residential customers, the most important factors in determining the potential for savings were gas costs and administrative charges; where an LDC's gas costs were higher, the potential savings were greater and where an LDC's administrative charges were allocated more to its distribution service rather than its supply service, the opportunity for savings were diminished. For commercial customers, the most significant factors for savings were the administrative charges, state and local taxes (which are imposed more heavily on LDC supply customers than distribution customers), and mandatory release of upstream capacity to customers.[167]

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162 *Supra* note 114.

163 *Supra* note 55.

164 *Ibid.*

165 *Policy Statement Concerning the Future of the Natural Gas Industry in New York State and Order Terminating Capacity Assignment* (3 November 1998), 93-G-0932, 97-G-1380 (N.Y. P.S.C.).

166 BENTEK Energy Research Inc., *Retail Gas Markets: How Open Are They?* (1998) [unpublished, archived at Bentek Energy Research, Lakewood, Colorado] [hereinafter *BENTEK Study*].

167 This finding agrees with that of the *GAO Study*, *supra* note 55.

Lower customer prices would be one hard measure of the benefits of unbundling, and unbundling will only constitute good public policy if its benefits exceed its costs. The costs and benefits of unbundling should be assessed on a number of criteria including: (1) prices paid by customers both in the short and long run; (2) the number and type of customer choosing to participate; (3) the market share of the different competitors over time; and (4) the ramifications for reliability in the near and long term.[168]

It is, however, difficult to quantify the benefits, and it is possible that the time frame for benefits to be realized extends beyond the test periods employed by public utilities commissions to evaluate the success of unbundling. *Gas Daily* reports that the United States Energy Information Administration ("EIA"), a primary source of energy price data, has stated that as gas users turn more to alternative suppliers, the "EIA's current data collection methodologies will be less and less able to accurately measure prices paid for gas in the residential and commercial sectors."[169] This is because the EIA obtains its pricing information from LDCs; as users go elsewhere, the LDCs no longer know how much those users are paying and can no longer give complete information to the EIA.[170]

While lower prices are the primary goal of competition, customer choice also ranks very highly as a benefit of unbundling, as evidenced in the lists of goals set out above. Customer choice allows each customer to tailor the package of services that it desires and to determine the price that it is willing to pay. Unbundling also reduces or eliminates cross-subsidization. It was the experience of industrial customers that arranging their own supply revealed that some services were mis-priced in the aggregate or not needed. This suggests that some services were subsidizing other services, and that some of these services could be provided more efficiently by competitors of the LDCs. Efficient pricing encourages customers to use energy efficiently. Efficient pricing also provides more reliable information to gas suppliers and should result in better decision-making in the planning, contracting, construction, and operations of their gas supply portfolios and systems.[171]

On the cost side of the analysis, the costs of unbundling include billing and administrative costs, stranded costs, system planning and reliability costs, the costs of serving low load factor customers, and the loss of economies of scope and scale. Additional billing costs for unbundled services are relatively small and relate to electronic data interchange of billing information and the printing of an additional line item on a bill. Stranded costs may increase. System planning and reliability costs may be increased insofar as the LDC will have to ensure that the alternative suppliers are in balance.[172] Low load factor customers may be more expensive to serve. There is a risk that economies of scale and scope may be lost. There is an increase in normal

168 *Supra* note 12.

169 *Supra* note 55.

170 *Supra* note 12.

171 *Ibid.*

172 Imbalances should be redressed with penalties, which serve two functions: (1) to compensate the LDC; and (2) to signal the supplier to do a better job of forecasting customer demand and procuring adequate supplies of gas.

business risks. With more suppliers in the market, there is more chance that any one of them may fail, causing the industry to incur the costs of bankruptcy or default.[173]

III. UNBUNDLING IN THE "GREENFIELD"

Greenfield jurisdictions — those with limited, or even non-existent, distribution facilities and markets for natural gas — pose a chicken-and-egg conundrum for regulators: which comes first, the market or fully unbundled competition?

A. THE PROPER APPROACH

1. THE MARKET COMES FIRST

The natural gas industry in the state of Maine is considered a greenfield jurisdiction; however, the market is expected to expand by the end of 1999 with the addition of pipeline extensions bringing Canadian gas into the state from two directions. The Maine Public Utility Commission initiated an inquiry in May 1997 to consider the growth of the industry in light of the imminent pipeline expansions throughout the state. In particular, the commission was interested in determining whether directing new or expanding gas distributors to unbundle their services (as the first step of deregulation) would give momentum to the growth of the industry and lead the way for further unbundling. Interestingly enough, the commission determined that pursuing deregulation before the market was ready would hinder the efficient expansion of the industry and that, as a result, LDCs should continue to offer bundled services alongside new optional unbundled services. Two major concerns cited to support this decision were that: (1) complete unbundling could seriously impede new infrastructure investment due to the uncertainty of relying upon unregulated gas suppliers to develop the market; and (2) unbundling is considered most successful in those jurisdictions where a mature gas market exists, and Maine lacked the existing customer base to leverage for competition.[174]

North Carolina is another state in which a greenfield gas distribution utility has recently been authorized and is currently under construction. That utility, Frontier Utilities of North Carolina, Inc. ("Frontier Utilities"), will serve four rural counties in North Carolina that have not previously had natural gas service. It will offer bundled gas sales and transportation services. The utility's sponsors apparently did not propose a fully unbundled alternative, and the North Carolina Utilities Commission did not require Frontier Utilities to offer one.[175]

Certainly, the jurisdictions, such as Ontario, which have had the greatest success in developing a retail natural gas market have done so in a bundled environment.

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[173] *Supra* note 12. This is a risk that may be minimized through licensing of gas suppliers.

[174] "Maine Regulators Deem Gas Unbundling 'Premature'" *Gas Daily* (4 March 1998) 15:43 online: NEXIS (Energy, CURNWS).

[175] *Re Frontier Utilities of North Carolina, Inc.* (1996), 166 P.U.R. (4th) 565 (N.C. Utilities Comm'n).

However, this does not mean a robust retail market could not be developed, and even developed faster, in an unbundled environment.

2. COMPETITION COMES FIRST

Jade Alice Eaton, a trial attorney in the Anti-trust Division of the Department of Justice, recommends that greenfield international jurisdictions should learn from the experience in the United States and avoid a difficult period of over-regulation prior to entering the new world of deregulation.[176] Her view is that much time and effort may be saved in fledgling natural gas markets by proceeding directly to a fully unbundled market where LDCs do not act as gas suppliers. The problem with this assertion is the lack of practical experience in North America to test it. Intuitively, though, it makes sense that the quickest way from point A (the greenfield) to point B (a fully competitive, mature gas market) is a straight line, without meandering down the muddy path of introducing bundled services and the process of unbundling those services at some later date.

3. A HYBRID APPROACH

It may not be a chicken-and-egg question after all; instead, it may be a case of "what comes around, goes around." The Ontario Energy Board has explicitly acknowledged[177] that its recommendations for revisions to its enabling legislation were based in part on the gas distribution legislation of Nova Scotia and New Brunswick,[178] which had in turn been derived partly from the experience of jurisdictions such as Ontario. In particular, it borrowed the concept that the regulator should have authority to: order the removal from regulation or redefinition of LDC services, supervise restructuring to separate regulated services from unregulated services, establish and enforce rights of supplier access to LDC services, enforce codes of conduct, and choose the most appropriate means of regulating monopoly services.[179]

History in North America teaches that a mature retail gas market can be developed with bundled distribution services. However, this history offers no examples of a greenfield market developed from its inception on a fully unbundled basis. Meanwhile, theory dictates that a fully unbundled environment should be the starting point to develop a mature retail gas market without the messiness of the whole unbundling process.

Which is the proper approach? Perhaps neither. There may be a hybrid approach, not unlike the transitional period many jurisdictions are now experiencing; that is, to give customers a choice between bundled services from the LDC and unbundled services from competing gas suppliers. With this option, the market will be left to decide the

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176 *Supra* note 16 at 125.

177 *Unbundling Report*, *supra* note 34.

178 *Gas Distribution Act*, S.N.S. 1997, c. 4 [hereinafter *Nova Scotia Act*].

179 *Unbundling Report*, *supra* note 34.

best way to mature, at least in theory. If the market is indeed left to decide which approach it prefers, and if the LDC offering bundled service does not have an insurmountable advantage by virtue of its status as the franchised utility, this approach might work. It reduces the uncertainty associated with full competition at the outset, as feared by the state of Maine, while providing the benefits of competition right away. On the down-side, this solution entails some of the complications being experienced in the jurisdictions that are in the process of unbundling; in particular, a mechanism will need to be devised through which the LDCs will be required to exit the supply function at some appropriate point. Moreover, it is not at all clear that a market in which the utility is permitted to offer bundled services will prove attractive enough to entice independent marketers to enter. They could decide that the advantage the LDC enjoys as bundled service provider is simply too great, just like Enron and the others who have decided to avoid the residential market until competitive conditions improve.

Any of the three approaches discussed above should achieve the goal of developing a competitive retail natural gas market with varying degrees of success over some period of time. However, the *best* way to develop a greenfield market in North America remains to be seen and will vary depending on local circumstances. The next few years will provide a unique opportunity to compare alternatives for the establishment of a greenfield gas utility as Nova Scotia and New Brunswick embark on this task with two slightly different approaches.

B. SPECIFIC ISSUES

While the approach chosen for the greenfield jurisdiction will have some bearing on which of the key issues discussed earlier will apply, there are some certainties; any jurisdiction requiring unbundled gas distribution services must deal with issues of affiliate rules, obligation to serve and reliability, customer mobility, consumer protection and education, and pricing. Market entry will be an issue to a small degree, as it is in any competitive industry, but there will be no issue of stranded costs and likely no need to develop an unbundling process beyond charting the exit of the LDCs from the supply function, if required, at the appropriate point in time.

C. NOVA SCOTIA AND NEW BRUNSWICK

It is readily apparent on first glance at the *Nova Scotia Act*[180] and the *New Brunswick Act*[181] that the two provinces have taken a different approach in their gas distribution legislation: the *Nova Scotia Act* is forty-five sections long, while the *New Brunswick Act* is more than twice that length, at 106 sections. Part of the difference in size of the two Acts is that the *New Brunswick Act* covers pipeline construction and storage, matters that are dealt with in Nova Scotia legislation other than the *Nova*

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180 *Supra* note 178.

181 Bill 25, *Gas Distribution Act, 1999*, 4th sess., 53d Leg., New Brunswick, 1999 (assented to 12 March 1999) [hereinafter *New Brunswick Act*].

Scotia Act. Also, two sets of regulations covering gas distribution matters[182] have been promulgated under the *Nova Scotia Act*, whereas currently no regulations have been promulgated under the *New Brunswick Act*. Even so, the *New Brunswick Act* takes a more detailed approach than does the *Nova Scotia Act* (together with the *Nova Scotia Regulations*). It can safely be said that New Brunswick has tended to favour certainty in its legislation, whereas Nova Scotia has tended to favour flexibility. This will become apparent as the ways in which the two provinces have dealt with various issues is examined below. It should also be recognized that the legislation will only be one piece of the gas distribution and sales structure in each province; there will be policies, rule-makings, rate cases, and other statutory instruments in the months and years to come.

1. EXTENT OF UNBUNDLING

Both provinces have opted for a fully unbundled environment right from the beginning with LDCs prohibited from selling gas, subject to certain exceptions. These exceptions are important, however.

Section 30 of the *Nova Scotia Act* provides that an LDC may not be licensed to sell gas to "consumers" (defined in s. 20 of the *Board Regulations* to be persons consuming less than 500 gigajoules of gas annually). However, s. 13(1)(j) of the *Nova Scotia Regulations* stipulates that an LDC "may sell gas upon such terms and conditions as are determined by the Board, and in making such a determination, the Board shall restrict such sales to those necessary for the effective and efficient operation of the gas delivery system." This leaves open the possibility of the LDC providing SOLR services and selling to consumers of more than 500 gigajoules annually, and it may allow an LDC to provide bundled services if the Nova Scotia Utility and Review Board is of the opinion that the efficiency of the system requires it. It can be (and has been) argued that if the board decides that market expansion, which contributes significantly to system efficiency, requires the distributor to provide bundled services, that option may be made available by the board under the *Nova Scotia Act*.

The *New Brunswick Act* is a little more limited in its approach. Subsection 51(1) provides that "[n]o gas distributor shall sell gas except as a supplier of last resort but ... an associate or affiliate of a gas distributor may sell gas." Thus, there is no opportunity for LDCs to provide a bundled supply service in New Brunswick. The *New Brunswick Act* also makes it clear, in s. 14(2), that an LDC is a common carrier.

2. AFFILIATE RELATIONSHIPS

Both provinces permit LDC affiliates to act as gas suppliers, but the Acts are both cautious about LDC-affiliate relationships.

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[182] *Gas Distribution Regulations (Nova Scotia)*, N.S. Reg. 86/98 [hereinafter *Nova Scotia Regulations*] and *Board Gas Distribution Regulations (Nova Scotia)*, N.S. Reg. 93/98 [hereinafter *Board Regulations*].

Under s. 5(e) of the *Nova Scotia Regulations*, an applicant for a distribution franchise must provide:

> commitments satisfactory to the Board to encourage competition among agents, marketers and brokers in the sale of gas within the proposed franchise area by specifying,
>
> (i) in a code of conduct filed with the Board, the relationship between the applicant and any marketing affiliate and the degree of separation between the applicant and any marketing affiliate [not defined], and the steps the applicant proposes to take to ensure that its marketing affiliate gains no competitive advantage as a result of its affiliation with the applicant, and
>
> (ii) the availability to all affiliated and unaffiliated marketers of detailed market information including name, address, telephone number and energy usage of customers and potential customers in the proposed franchise areas.

Once the applicant becomes an LDC, it must maintain and abide by the code of conduct provided as part of its application[183] and provide marketing information "to all gas sellers (affiliated and non-affiliated alike) ... on an individual, non-aggregated basis...."[184] Nova Scotia thus has flexibility over the contents of LDC codes of conduct and the degree of separation required between LDCs and their affiliates.

The *New Brunswick Act* is much more specific on this issue. Part 6, entitled "Rules of Conduct," sets out New Brunswick's approach. Section 66 of Part 6 contains the rule-making power of the New Brunswick Board of Commissioners of Public Utilities. In particular, the board may make rules "governing the conduct of a gas distributor as that relates to its affiliates or associates," governing the conduct of gas marketers and setting out reporting requirements for LDCs and gas marketers.[185] Further, s. 69 of Part 6 sets out in detail the obligations of an LDC to:

> (a) apply the terms and conditions of its tariff ... without regard to the supplier of gas;
>
> (b) process all similar requests for service in the same manner for all gas marketers in a reasonably similar time period;
>
> (c) make no unjust discrimination ... among gas marketers ... in matters relating to the movement or delivery of gas ... or the administration of contracts, including the provision of customer services;
>
> (d) apply, without unjust discrimination, the same tariff relating to discounts, rebates, fee waivers, or penalty waivers to all similarly situated customers, without regard to their gas marketer;
>
> (e) make no unjust discrimination in applying any discretionary right under a tariff to similarly situated customers, but serve them without regard to their gas marketer;

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183 *Nova Scotia Regulations*, *ibid.*, s. 13(1)(f).

184 *Ibid.*, s. 13(1)(g).

185 "Affiliate" is given the same definition as the one under New Brunswick corporations legislation.

(f) make no unjust discrimination in offering discounts, rebates, fee waivers, or penalty waivers to similarly situated customers, but serve them without regard to their gas marketer ...;

(g) make no unjust discrimination among gas marketers in scheduling or allocating capacity at a city gate station;

(h) make no unjust discrimination in matters relating to ... transfer of the gas distributor's capacity rights on ... a pipeline ...;

(i) not represent that any advantage accrues to customers or others in the use of the services of a gas distributor because that customer or others deal with a gas marketer associated with the gas distributor;

(j) provide no preferential sales leads to any gas marketer, and refrain from giving any appearance that the gas distributor speaks on behalf of any associated gas marketer;

(k) allow no joint solicitation calls on customers by personnel of the gas distributor and any gas marketer, unless a customer specifically requests a joint meeting in advance in writing;

(l) at any given time, disclose information provided to any gas marketer about the marketing or sale of gas to customers or identifying potential customers or about the delivery of gas to or on its system to all gas marketers on the system, by posting the information on its electronic bulletin board;

(m) not knowingly disclose to any gas marketer any confidential information obtained in connection with providing services to any other gas marketer or customer, a potential gas marketer or customer, any agent of such a customer or potential gas marketer;

(n) ensure that employees of the gas distributor having direct responsibility for the day to day operations of its operations ... are not shared with any gas marketer who is an associate or affiliate, but are physically separated from it and function independently of it;

(o) file with the Board procedures that will enable gas marketers and the Board to determine how the gas distributor is complying with the standards set forth in this section;

(p) maintain its books of account and records separately from those of any gas marketer who is an associate or affiliate;

(q) respond in writing to the Board within ten days to any complaint submitted to the gas distributor in writing that relates to compliance with the standards set forth in this section; and

(r) not allow any associated or affiliated gas marketer to use its name or a material part of its name except as approved by the Board....

Of particular note are the prohibitions against the sharing of marketing efforts, employees and names, and the requirement to maintain accounting separation.

3. OBLIGATION TO SERVE AND RELIABILITY

Currently, neither the *Nova Scotia Act* nor the *Nova Scotia Regulations* contains any provisions relating specifically to an obligation to serve or service reliability beyond the power of the Utility and Review Board to approve provisions for the termination of distribution service,[186] the form of distribution customer contract,[187] and LDC gas sales for purposes of system efficiency.[188] These issues have been left open for the board to deal with under its generic power to develop standard terms and conditions for distribution franchises[189] or through future regulations respecting terms and conditions of gas sellers' licences.[190]

The *New Brunswick Act* does deal directly, and in some detail, with issues of obligation to serve and service reliability. As discussed above, the LDC is entitled to sell gas only as the SOLR, defined in s. 1 as "a person who sells or delivers gas where a gas marketer fails to supply gas to a customer on a timely basis and no other gas marketer is able or willing to do so." Under s. 51, the LDC is required to serve as, or arrange for, the SOLR. The board has the power to approve or fix the price for SOLR services pursuant to s. 52.

Part 8 ("Gas Priorities and Allocation") of the *New Brunswick Act* is intended to "provide for the fair allocation of gas where there is an existing or impending shortage of gas."[191] It requires, in s. 91, that each LDC and marketer file "allocation plans" with the board, setting out its available gas supply and how it intends to allocate that gas. The board may amend an allocation plan by order. In s. 92, the board "may direct a gas distributor or gas marketer to make available to another gas distributor or gas marketer such amount of gas ... and by such means, including sale, loan or otherwise, and on such conditions, including compensation, and to be used by the receiving gas distributor or gas marketer in such manner, as the Board may determine." Section 93 provides that compliance with such a direction by the board overrides any contractual obligation and no action may be brought in respect of it.

With respect to public policy issues, such as low-income customers, aside from the New Brunswick board's power, upon application, to order an LDC to distribute gas or provide any customer service under s. 15(2), there is no requirement on LDCs or gas suppliers to provide service to low-income customers, although the board does have the ability under its rule-making power to make rules establishing conditions of access to gas distribution and customer services.[192]

Finally, to ensure LDC performance of its obligations, an LDC may be required to provide financial security pursuant to s. 8(1)(c). There is no similar obligation on gas

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186 *Supra* note 183, s. 13(1)(h).
187 *Ibid.*, s. 13(1)(i).
188 *Ibid.*, s. 13(1)(j).
189 *Ibid.*, s. 14.
190 *Nova Scotia Act, supra* note 178, s. 41(j).
191 *Supra* note 181, s. 90.
192 *Ibid.*, s. 66(1)(c).

suppliers under the *Nova Scotia Act*, although the financial position of a gas supplier is relevant to the board's granting of a certificate to sell gas.[193]

4. CONSUMER PROTECTION AND EDUCATION

Both provinces require that gas sellers be licensed or certified.[194] The Nova Scotia licence is only required with respect to gas sales to customers with consumption of less than 500 gigajoules annually. The New Brunswick certificate, on the other hand, is required for all gas sales. However, a gas sales contract with a "low volume consumer," defined in s. 1 as a customer with consumption of 50,000 cubic metres or less of gas annually, is not enforceable against a seller who does not have a certificate.[195]

Under s. 26 of the *Nova Scotia Act*, the board may issue a licence upon terms and conditions which it considers to be appropriate. Another consumer protection element of the *Nova Scotia Act* is the recognition that customer information is to be kept confidential.[196]

Section 16 of the *Nova Scotia Regulations* ensures that all customers with consumption of less than 500 gigajoules annually will pay the same rate for distribution services. Also, the interest charged on late payments by any customer for distribution services will be capped by the board under s. 13(1)(e).

Part 5 of the *New Brunswick Act* is entitled "Gas Marketers" and deals with gas marketing matters, especially certificates for gas sellers. Section 61 provides that a certificate is subject to the terms and conditions that the board considers necessary in the public interest. A seller is not entitled to receive or renew a certificate if its financial position indicates that it cannot reasonably be expected to be financially responsible in the conduct of business or if its past conduct or the past conduct of its officers, directors, or associates[197] "affords reasonable grounds for belief that it will not carry on business according to law and with integrity and honesty."[198] As discussed above, the board may make rules governing the conduct of gas sellers and establishing conditions of access to gas distribution and customer services.

The New Brunswick board has the potentially very significant ability to regulate non-competitive prices for gas or customer services in s. 59:

> The Board may make orders regulating the price of gas, or of a customer service charged by a gas marketer, when it finds that the price is not subject to effective competition sufficient to protect customers' interests.

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193 *Supra* note 178, s. 62(a).
194 *Ibid.*, s. 24; *New Brunswick Act*, *supra* note 181, s. 58.
195 *Supra* note 181, s. 57.
196 *Supra* note 178, s. 13(5).
197 As defined in New Brunswick's corporations legislation.
198 *Supra* note 181, s. 62(6).

Section 53 of the *New Brunswick Act* provides that the board may also alter units of measure in an LDC's tariff to ensure that customer services can be compared to those provided by others.

Neither province deals with consumer education in its legislation.

5. CUSTOMER MOBILITY

Customer mobility is not addressed by either province other than as it may appear in the terms and conditions of a licence or certificate to sell gas. Otherwise, this will be a matter which is left to contract between the customer and the gas supplier.

6. PRICING

Certain pricing provisions have already been discussed in the context of consumer protection. In addition to those, both provinces give their respective board the power to approve or fix LDC prices.[199] Both explicitly recognize alternative forms of price regulation including performance-based rates.

7. OTHER MATTERS

Both Acts have teeth; it is an offence to contravene or disregard any of the provisions of the Acts or the regulations, rules, board orders, licences, or certificates issued thereunder.[200]

One last item of interest is found in the *New Brunswick Act*. Section 85 provides that where "the sale of gas or a customer service is or will be subject to effective competition sufficient to protect customers' interests," the board will forebear from regulating that service. The board also has the ability to forebear from regulation when it feels that to do so would be in keeping with the purpose of the *New Brunswick Act*. This provision is intended to respond to the development of competition.

IV. CONCLUSION

The unbundling of gas distribution services is occurring in more jurisdictions than not in North America. In the few places where it is not happening, either the idea has been considered or gas is not available at all. There are common issues facing each jurisdiction, but they may be viewed differently from case to case. The approach to dealing with each issue is equally varied. The speed at which unbundling is happening ranges from snail-like to downright speedy (in regulatory terms, anyway).

Unbundling has been a clear success for large customers, but for small customers the benefits are not so clear — yet. There seems to be faith in most jurisdictions, even

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199 *Nova Scotia Act*, *supra* note 178, s. 22; *Nova Scotia Regulations*, *supra* note 182, s. 15; *New Brunswick Act*, *ibid.*, s. 52.

200 *Nova Scotia Act*, *ibid.*, s. 37; *New Brunswick Act*, *ibid.*, s. 97.

those like Nova Scotia and New Brunswick that have never had gas, that unbundling gas distribution services is appropriate and should be pursued. As the movement grows and develops, it will become evident what works and what does not. Even now, the lessons learned in other jurisdictions are being put to use elsewhere to create opportunities for customers and industry alike. The next several years will tell whether these students of unbundling have really done their homework.