Natural Gas Unbundling in Kentucky:

Exploring the Next Step Toward Customer Choice

Comments of the

Kentucky Energy Policy Center

to the

Kentucky Public Service Commission

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Introduction

The Kentucky Energy Policy Center is a newly-formed coalition representing the interests of small energy consumers and is made up of environmental and consumer groups concerned about the risks created by the movement toward deregulation in the energy industry. The purpose of the center is to represent the interests of small utility customers in order to assure fair and affordable pricing, environmental sustainability, safe and reliable service and fair treatment of consumers.

These comments will address questions and options presented by the Commission in its July 11, 1997 report on gas unbundling in Kentucky, and make recommendations that KEPC feels are in the best interests of the public, small customers and the environment. The complexity of the issues makes detailed proposals and positions inadvisable at this early stage of the discussion. The broad public policy issues have been clearly stated by the Commission, and deserve ongoing study and consideration.

1.) Customer Choice and the Public Interest

The Commission asks whether or not the residential gas market should be opened to choice of supplier. The answer is easy: only if it is in the public interest. The public has a right to receive safe and reliable gas service at fair, just and reasonable rates that is superior to the right of gas suppliers and marketers to profit from doing business in Kentucky. Unbundling of residential gas service carries considerable risks which offset opportunities for benefits, and should not proceed if the only benefit is to let suppliers solicit customers' business.

The report acknowledges that no one expects small customers to see much, if anything, in the way of savings on bills. (At best, 5% of the gas supply portion of the bill.) The big question on the table is why is the PSC pursuing this if no significant savings are projected? Some of the utilities have suggested that choice of gas supplier alone is desirable enough to justify going forward, and the PSC seems sympathetic to that position. Everyone else seems skeptical about the benefits of unbundling small customers. A look at the advantages and disadvantages shows why:

ADVANTAGES.	DISADVANTAGES
1) Choice	1) Possible Higher Gas Costs
	2) Additional Administrative Costs
	3) No Obligation to Serve
	4) Less Reliability (Buyer Beware)
	5) Stranded Costs
	6) Customers Pay for Education
	7) Customers Pay Cost of Marketing
	8) High Cost of Standby Service
	9) No Regulation of Marketers
	10) Uncontrolled Cost of Other Services
	11) Lost Tax Revenues
	12) Loss of conservation and low income assistance programs

With the balances tipped so strongly toward the disadvantages, it is not surprising that small customers and their representatives are not the ones pushing for competition and further unbundling. The push is coming from two parties. The first is marketers. Their goals of maximizing profits in an unregulated environment is not consistent with the current regulatory environment, which seeks to keep utility prices reasonable.

The other group that is pushing for deregulation includes some of the current gas utilities, although the PSC report notes that at least one of the five major gas utilities in the state is very skeptical. On the surface it might seem that the gas utilities would oppose competition, since they could lose some of their current customers to marketers or other utilities. A closer examination of their present situation is necessary to understand their support for undbundling.

Good examples would be the Louisville Gas and Electric Co. (LG&E) and Union Light, Heat and Power (ULH&P). These utilities make a profit in the form of a rate of return on their investment in their systems. Both of these utilities have older systems that are fairly well depreciated, limiting the amount of return they receive. The result is that the majority of customers' rates is the cost of gas, which is simply passed through, and administrative costs. Even in the best of times these utilities realize very little profit from the gas portion of their businesses. But these are not good times for these utilities. Utilities have lost many of their high-volume (industrial) sales to marketers. And both of these utilities have experienced a drop in use per residential customer over recent years. Thus adding new customers, which has a significant cost, is only replacing lost sales to existing customers. While regulation has kept prices low for small customers, it has also not produced ever-increasing profits for gas companies. Since in a regulated environment some companies have stagnating profits, elimination of regulation is seen as the mechanism for increasing profits

Deregulation and competition would open up a range of ways for gas companies to increase profits. Beyond simply raising prices, there are other ways that profits might be increased. A company like LG&E has large gas storage fields in which they put cheap summer gas, and then use this gas in the winter for their customers, when gas prices are much higher. LG&E's small customers enjoy some of the lowest gas prices in the country because of these gas storage fields that have been developed to serve them. But in an unregulated environment, LG&E could use these storage fields to buy cheap summer gas and then sell it at market prices in the winter.. The potential profits could be enormous compared to the relatively small profits they now receive from their gas business. The losers could be current LG&E customers that presently pay much lower rates for gas because of those storage fields, that would then have to pay market prices for gas. This example is one of many reasons the utilities are pushing for natural gas deregulation and their customers are skeptical about it.

It should also be noted that the only choice being discussed is choice of supplier. Customers would still have to deal with their current gas utility, who would become the local distribution company. This fact places two major limitations on the real benefits customers might see:

* The cost of transportation and distribution make up a significant percentage of customers bills. Changing suppliers will not lower these costs. A 10% savings on gas supply does not translate into a 10% savings on bills.

- Many of the problems small customers experience with their gas service relate to distribution level issues, including such areas as billing and metering, customer service, shut offs and repairs. Unless these services are also made competitive (as some marketers, such as Enron, have proposed) the positive effects of the choices being offered are limited.

2.) Savings for Small Commercial and Residential Customers

As noted above, no one is predicting significant cost savings for residential customers if there is choice of supplier. The report asks if lower prices are the only reason to unbundle. KEPC feels that, while no positive benefits of unbundling have been shown, it should not proceed unless it can produce real cost savings.

There are many practical considerations that affect the potential for cost savings. For example, while the PSC report goes into great detail with respect to theoretical unbundling for small customers, it does not address the technical complexities of such a proposition. In the Delta Natural Gas rate case currently ongoing, the Commission asked Delta why they didn't offer unbundled service to smaller customers, and the answer provides a reality check for this whole process. The case reflects that there would be additional costs associated with the administration of these services, including nominating, tracking and balancing the gas delivered to the city gate and the gas actually used by these individual customers on a daily basis. These costs;

as well metering and telemetry costs, are minor for large volume customers when compared with the total cost of gas that they use. For small customers that might use $500 worth of gas a year, the additional transaction costs could be staggering. Beyond the obvious question of who will bear these additional costs, the size of these costs relative to any minor theoretical cost savings in gas prices must be weighed.

KEPC does not believe that a case has been made that unbundling for small gas customers is in the public interest. There are, however, problems within the current system that should receive some attention, including cost-shifting, and the perpetuation of the gas adjustment clause.

1) Cost Shifting: Residential Ratepayers Should Not Bear A Disproportionate Share of Fixed Costs

In recent years, allocation of costs among customers often reflects a shifting of fixed costs away from large customers to smaller customers. An example of this phenomenon is in the Cost of Service Study recently filed by Delta Natural Gas in a pending rate case, in which the on-system industrial customers pay only 10% of the revenues proposed to be collected even though accounting for 43% of the total gas throughput for the Delta system. While some of this disparity can be explained by gas transported through the system, there appears to be a lack of parity in allocation of the costs. In that same study, only 1/2 of 1% of the cost of gas mains appears to be allocated to industrial customers despite the 43% use by that class of customers. This apparent disparity in allocation of fixed costs has been challenged by the Attorney General's office.

Recommendation: Fair allocation of fixed costs among all customers must be assured and disparities corrected. The costs associated with unbundling small customers must be seriously studied by the Commission before proceeding any further.

2) Gas Adjustment Clause: No Guarantee That LDCs are Getting Best Prices

If the Commission is searching for areas where *real* savings are possible for consumers and ratepayers, the elimination of the Gas Adjustment Clause should be considered. Since any increases or decreases in gas costs are simply passed through to the customers, the utility has no incentive to buy the lowest-cost gas. In fact, the opposite may be true, to the extent that the gas purchase is from an affiliated gas supplier, since any higher costs might be passed on to customers as greater profits would be captured by the affiliate. The Gas Adjustment Clause is simply not appropriate in today's marketplace.

Recommendation: Some mechanism is needed to ensure that any captive customers, or those served by a supplier of last resort, get the best gas supply possible. Small customers might receive the benefit of the marketplace, without the high cost and associated chaos of retail competition, if: the Gas Adjustment Clause were eliminated; Local Distribution Companies (LDCs) were prohibited from buying gas from affiliates at unjustified prices; if marketers could bid on LDC gas purchase contracts, and if the PSC reviewed all bidding processes and signed contracts. The incentive would be for gas companies to keep gas prices at current levels (or an average cost of the last three years). If they could buy gas at a savings, they could keep the profits, but if they do a poor job of keeping prices down, they would pay the difference.

3) Legal Authority of the PSC to Proceed With Small Customer Unbundling

The Commission seeks opinions as to whether further gas unbundling and competition require additional statutory authority, and also whether the Commission should open a generic administrative proceeding to consider the issues involved in gas unbundling.

The KEPC believes that specific statutory authority addressing the many complex public policy decisions involved in natural gas unbundling, is needed both to assure open and comprehensive assessment and debate on the future of the regulation of natural gas, and also to avoid challenges to the authority of the Commission as would like arise if the Commission proceeds under its general powers.

The changes under discussion represent a fundamental shift in the regulation of the gas industry, and as such, should not be undertaken without enabling legislation granting the Commission specific authority to consider such changes (as was provided for telecommunication services by KRS 278.512). Much of the public, and many of the elected officials in the Commonwealth, are not sufficiently informed and enfranchised in a debate as significant as that of natural gas unbundling, and a specific grant of authority establishing both the power and providing some specific direction on significant public policy decisions *if* it is determined that unbundling is consistent with the public interest, is far preferable to unilateral Commission action.

In addition, the creation of "competition" for natural gas service must be seen in the larger context of a competitive market for energy services, Many areas of the state are served by separate gas and electric suppliers. The unbundling of gas services, particularly if coupled with universal service obligations for gas providers, may have some impact on the energy services market as a whole. Introduction of new competitors offering "loss leaders" to enter markets may have similar unanticipated consequences. Further study and broad public debate is needed on both gas and electric utility deregulation and restructuring before moving forward in either arena.

The Commission has begun an important process of seeking input from various interested groups in providing some meaning to the buzzwords of "competition" and "restructuring," and the meetings with various groups as well as release of this natural gas unbundling report have similarly been helpful in identifying issues of concern to the various groups. KEPC believes that this process of engaging the public and various interests within the public in the assessment of these important issues has just begun.

KEPC does not believe that a compelling case has been made that electric utility deregulation and gas unbundling is in the public interest. Comprehensive study of the risks and impacts, and of the questions raised in these comments, is needed before any further action is undertaken. After a full and fair opportunity for public education and participation, *if* a consensus can be forged, specific legislative authority to move forward with unbundling should be obtained prior to taking action.

KEPS has a strong interest in the Commission continuing to facilitate the dialogue, in the belief that such a continuing dialogue can best produce a consensus. Any responsible consensus should satisfy the goals of universal service, environmental responsibility, and consumer protection; meeting the needs and concerns of the public in the event that movement is made towards the goals of less regulatory structure and more competition.

Whether a generic proceeding is the best mechanism for this continuing process is questionable, since some generic proceedings have not provided useful discussions of public policy. The informality of the current focus-group discussions is more useful in exploring the interests and concerns of the differing interests, and is more useful in trying to forge a consensus concerning what a legislatively-authorized gas unbundling or electric deregulation framework should entail. A generic hearing would be more useful in reviewing and developing implementation guidelines once legislation is enacted. At this time, however, making a formal record is much less useful than informal discussion in exploring the many ramifications of these proposals.

KEPC is committed to advancing rational discussion of energy issues in order to promote the public interest. To this end, KEPC welcomes and encourages creative thinking on energy issues. There is a great potential for public harm in poorly-conceived "deregulation," and also a potential that should be explored for significant improvements in the current structure of energy delivery aside from unbundling and deregulation.

Recommendation: KEPC recommends that the Commission continue to facilitate discussion of these issues, and broaden the debate by engaging in public education, with the purpose of achieving public consensus on areas of agreement concerning the regulation of energy services. Unbundling should not be undertaken without consensus on such areas as universal service, environmental responsibility, and consumer protection. Statutory changes should follow, not precede, such a consensus. A generic case is not appropriate at this juncture, and should be used to focus on implementation issues is and when a statute is passed.

4) Implementation Issues

a) Aggregation

The report presents a very limited discussion of aggregation of customers. The LDCs raised minimum volume requirements, and the independent marketers appear to be looking at aggregation of meters only for large commercial customers.

The scope of the inquiry into aggregation should be expanded, since it is likely the only vehicle for real cost savings for small customers. If the ground rules for aggregation are not fair and clear, redlining of residential customers can occur. For example, developers could aggregate high income home-buyers, while people in low-income neighborhoods could not get the time-of-day from marketers.

Any discussion of aggregation must make clear who the "aggregators" are and who represents the consumers' interests. An Environmental Action report on aggregation points out that "[t]here is an important distinction between aggregated buying power and aggregators of buyers. Privately owned utilities and power marketers, wich can function as aggregators of buyers, do not represent consumer interests. These companies are not end users, but middlemen. They do not protect or represent the interests of the ultimate purchasers or the public at large."[1] Examples of how consumers can aggregate themselves are discussed under "Additional Options" at the end of these comments.

Recommendation: No small customer or commercial unbundling should take place unless mechanisms for aggregation are in place and are reasonably accessible. The PSC should broaden the scope of its study of this issue, as it is likely the only realistic means of achieving real cost savings for residential customers.

b.) Conservation

The PSC report's discussion of energy conservation is limited to programs for low income customers. While these programs are important, they do not account for the full range of current conservation activity. Conservation should be a public policy priority that is protected in any changes made to the energy industry in Kentucky. All service territories should be served by such programs.

The report states, on page 12, that of the four DSM programs currently in existence, three address primarily electric issues and one involves a gas only utility. This is not accurate. Two of the four utilities involved in demand side management programs are combined gas and electric utilities, and have programs that address both fuel sources. These programs represent the minimum options that should be available to consumers statewide: cost effective installation, financing of energy efficiency appliances and products, and energy education.

Recommendation: Conservation is a public policy good that needs to be protected and enhanced for all customers and be part of any new gas industry structure. It can be funded through a surcharge on mcfs and be collected by LDCs. The LDCs should NOT run these programs, as they have a potential conflict of interest because their profits are based on volume of sales, and conservation reduces that volume.

c.) Universal Service

One of the most critical questions raised in the PSC report relate to whether or not low income assistance is a "societal" or "utility" problem, meaning should the issue dealt with in the context of the PSC and/or with utility and marketer participation, or is it left to the legislature or social service agencies to deal with? The smaller questions relate to the impact of deregulation on

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[1] *Group Buying Power: Meaningful Choices for Energy Consumers*, Sec. 2.2, Environmental Action and Kay Guinane, May, 1997

existing programs and how new programs would be funded and implemented.

Universal service in the energy industry is an evolving concept. It includes not only affordability, but access to reliable service. The PSC's policy on low income issues has been based on a industry structure which includes the obligation to serve. Elimination or weakening of that obligation by competition creates new risks for low income customers, and when they are shut off it creates problems not just for them, but for the communities where they live. Thus the public interest is directly affected by the shift to competition.

Rural access is important element of universal service, but takes on a different character in gas than it does in telecommunications. The problems of rural customers do not relate to line extensions and related costs. The dangers are more similar to what has happened with health insurance: the number or competitors, and the resulting number of options available, is likely to be smaller in rural areas, based on the cost of service. In an unbundling scenario rural customers could lose regulatory protections and effectively remain captive customers while others get choice.

These risks can be offset and the public interest protected by establishing a principle and definition of universal service. Elements of universal service are: accessibility, affordability, safety and reliability. Once this is done, a means achieving these goals must be identified.

The PSC report poses two sets of questions regarding the impact of unbundling on programs that assist low income customers. These programs include the federally funded Low Income Home Energy Assistance Program (LIHEAP) and Weatherization Assistance Program (WAP), demand side management programs, utility based financial assistance programs such as the Columbia Gas Percentage of Income Plan, local government assistance and privately funded efforts like fuel funds and the efforts of community ministries.

The first set of questions relate to the future of these programs if unbundling is implemented. For non-utility based programs, implementation of unbundling would require new procedures for coordination with LDCs and suppliers and ironing out of such issues as where do payments get sent: the LDC or the supplier? Utility based programs become "stranded benefits." These programs can be expanded and continued outside the sponsorship of the LDC and/or former supplier. Currently these programs are only available in limited areas. Implementation of unbundling creates an opportunity to make these programs and their proven benefits available to qualifying customers in all service territories. In many states where electric restructuring or gas unbundling is being implemented, these programs are funded by a charge on suppliers and administered by independent agencies.

The second set of questions raised by the PSC relate to shut offs. It is not clear who would have the responsibility for shutting off customers who cannot or do not pay their bills if unbundling were to be implemented. Many states that have passed restructuring legislation have dealt with this problem by prohibiting shut offs due to non-payment to alternate suppliers.

Instead, the supplier can drop the customer, who is then served by the supplier of last resort, who can only disconnect for failure to pay charges owed it.[2] However, many questions remain on how the day to day details of such arrangements will be carried out.

The Georgia gas unbundling legislation is not an appropriate model for universal service, as it only benefits utilities by paying for line extensions and uncollectible bills. Most gas main extensions are not to bring the customer their only heating option, but are an attempt to take gain market share by switching electric customers to gas heat. Ratepayers do not have a societal obligation to assist their local gas utility in a competitive battle with electric utilities. As a result, any main extensions should be paid for solely by the gas company's shareholders, and in a competitive environment, by the LDCs shareholders, gas supplier's shareholders and new customers only.

Recommendation: A principle of universal service that protects vulnerable customers and the public interest must be part of any unbundling plan or move to alternate ratemaking. In the past the grant of monopoly status to utilities in exchange for regulation has been called the "regulatory bargain." Deregulation of price and elimination of the obligation to serve should not take place unless universal service and environmental sustainability are ensured. This is the "deregulatory bargain."

Universal service is not limited to low income programs, but includes rural access and public institutions like libraries and schools. Any programs should be administered by the best qualified entity, and not the LDCs or the supplier of last resort. The program administrator should be independent, set goals and ensure outcomes consistent with those goals.

No unbundling of small customers should be accepted unless all small customers, including those in rural areas, can take advantage of it. (Note: Aggregation is the logical solution to the problem of rural access to choice.)

d.) Regulation of Marketers and Customer Protection

The marketers that want access to captive customers are not currently regulated. The PSC decided not to regulate them when it unbundled service for large industrial customers. The LDCs and their affiliate marketers do not want regulation of marketers if unbundling is extended to small customers. The report shows that they want to do the regulating themselves, through conditions placed in tariffs or contracts and by taking responsibility for dispute resolution. This puts the LDCs in charge and should be rejected outright. The history of the utility industry demonstrates that important public interest matters such as consumer protection cannot be made voluntary. They are too crucial. The report also indicates that marketers state that they should be

[2]*Comparison of Consumer Protection and Universal Service Provisions of State Legislation and Commission Decisions on Retail Electric Competition*, Barbara R. Alexander, June 6, 1997

required to serve anyone, but no details are given. Does this mean they won't reject customers with bad credit ratings, exclude those in rural areas or those with low usage? It should.

Independent marketers see the PSC being more active, setting guidelines for conduct. The Attorney General's office thinks a license should be required, with the PSC having a broad role to address fraud and customer service issues. The LRC also suggests the PSC set standards, including conditions for contracts between marketers and LDCs and marketers and customers. They also propose a Code of Conduct. The residential groups raised this in the context of consumer protections, mentioning payment plans, shut offs, reliability, reconnection costs and late charges. All these ideas need further exploration.

Price comparability is also an issue. The report raises it as a reliability issue, with one suggestion that LDCs establish a common unit of measure for gas so that customers can compare offers.

Recommendation: Marketers should be regulated, as small customers do not have the clout or resources that industrial customers can use to protect themselves in the marketplace. Unbundling small customers creates new problems and issues that will require new types of customer protections. Merely keeping existing protections in place is insufficient. No plan should go forward until careful study has been made of what these protections should be and how they can be enforced. There is plenty of material out there to draw on. General consumer protections statutes are insufficient. They require individuals to sue in court, and customers can't afford that. And the remedies they contain are not meant to address the needs of energy consumers.

The PSC, not the LDCs, should establish a common unit of measure of the cost of gas and other means of making comparison shopping possible.

e.) Stranded Costs

In the report the PSC points out that pipeline contracts will expire between Nov. 1998 and 2002, and that waiting for expiration eliminates the stranded cost problem. This makes good sense and should be the policy. It also then allows time for careful study of unbundling and a determination of whether or not it is in the public interest, not just marketers and utility affiliates.

Recommendation: If any unbundling occurs it should not take place until current pipeline contracts expire.

f.) Supplier of Last Resort

This issues covers what happens when a customer either does not choose an alternate supplier or cannot get service from one. The role of the LDC in this situation can be crucial. LDCs see themselves only providing this service in a transition period. The need for a "default pool" or supplier of last resort will be ongoing. Participation rates in natural gas competition programs in California and Ontario show that many customers will not choose alternate suppliers, foregoing the hassle of shopping.[3] However, the LDC is not necessarily the only entity that can provide this service. The load involved can be subject to competitive bid, thus increasing the chances that all customers will benefit from competition.

Supplier of last-resort issues also arise when alternate suppliers fail to deliver gas. The affiliate marketers suggest that the LDC provide back up service in this situation, but be paid the full cost of replacement gas, which will be high. The questions remains: who pays the difference between the contract price and the back up price charged by the LDC when a supplier can't deliver? There needs to be a requirement that the supplier, not the consumer, pay, and post a bond against this possibility. The PSC's comments on this issue admit that a buyer beware approach is insufficient, but the discussion in generally narrow..

Recommendation: In an unbundled environment the supplier of last resort should be a competitively bid role, not one that automatically goes to the LDC.

g.) Collaboratives

The report suggests that several major issues be referred to a collaborative process for resolution. These are public education, a suggestion by the affiliated marketers that a collaborative approach is the best way to approach further unbundling and whether or not to produce a pilot program. The PSC says the use of collaboratives should be "strongly encouraged."

Recommendation: The use of collaboratives is not an appropriate approach at this time. The changes being contemplated are major and can have very widespread impacts. The appropriate context for discussion and debate of these issues should be in an open, public setting where all parties have an opportunity to be heard and to reply to or rebut assertions made by others. Broad public outreach is needed to ensure that all affected parties have the opportunity to become informed and participate in the discussion.

This does not mean that informal discussions or negotiations between parties cannot take place, or that once major decisions have been made details cannot be worked out in a collaborative manner. But at this point, it would be premature to close the public debate.

h.) Market Power

LCD affiliates should not have any advantages over other suppliers if there is a truly competitive market. The PSC report reviews some methodologies for determining whether or not

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[3] *Can We Get There From Here? The Challenge of Restructuring the Electricity Industry so that We Can All Benefit,* Tellus Institute and Wisconsin Energy Conservation Corp., April, 1996

market power exists, but does not address means of preventing excessive market power from developing.

There is intense debate over whether or not LDCs should get out of the gas supply business and divest their affiliated marketing companies or be subject to Codes of Conduct that prohibit self-dealing and unfair use of their status as local distributor when competing for business on the supply side. There are good reasons for concern in this area. For example, in the direct access pilot in New Hampshire the state Commission took action to address anti-competitive behavior by the incumbent utility. After a complaint was filed by Enron Power Marketing, Inc. the New Hampshire Public Utilities Commission found legitimate concerns based on the actions of Public Service New Hampshire, and adopted standards which prohibit incumbent utilities' affiliates from suggesting that its relationship to the incumbent would result in more reliable service.

Recommendation: Codes of Conduct are helpful, but require constant policing and enforcement. Divestiture of affiliate marketers is the most effective means of dealing with this problem. In addition, the combined energy services market must be examined in order to ensure that combined gas and electric companies do not use their status to gain an unfair competitive advantage.

i.) Local Taxes

The report cites serious concerns relating to loss of local tax revenues if the current system is changed. School taxes, sales and use, gross receipts and property taxes can all be affected. A report produced for the National Council on Competition and the Electric Industry which warns of significant drops in local revenues is cited.

Recommendation: Local government needs to be informed and involved in this process as soon as possible. No drop in local tax revenues should result from any changes made.

5. Reliability

Many parties have raised concerns about the reliability of gas service in an unbundled environment. Will suppliers be able to deliver as needed, especially in severe weather? Will "firm" service be available or will it be "interruptible"? Should certain customers be required to get firm service?

LDCs will continue to be responsible for operation of the pipelines used by all customers, and the report states that "additional measures" may be required to assure that no one group subsidizes use of the LDC system by another. While the policy is a good one, specifics need to be developed. The PSC also stated that safety remains paramount.

Recommendation: Questions about reliability are of paramount importance, and all parties should work on solutions to the reliability problems in an unbundled environment. There are many more questions than answers, and this is yet another area that requires more study.

6.) What is Being Proposed: Options

The PSC has presented four options: "status quo" (with changes in rate regulation), pilot programs, broad unbundling and incentive programs. These are not necessarily the only options available. Some further options are presented at the end of this memo.

a.) Status Quo:

The PSC says the status quo "should probably only be selected in conjunction with incentive programs. This would provide both the utility and the customers opportunities to benefit from competition." p. 30 This statement appears to be inconsistent. The status quo is not the status quo if the Commission moves toward alternative ratemaking. The status quo is, and should be considered an option unto itself, with no modification..

If there is no demonstrated benefit to ratepayers from alternative ratemaking or unbundling, then the Commission would not be acting in the public interest to move toward adoption of those options. Choice without substantive distinctions is no virtue.

The utilities, their affiliated marketers and the independent marketers do not want to continue the status quo, as it limits their profits. The big industrial customers have their own deal and are happy. All the other groups expressed reservations about the benefits of change, but did not say the status quo is the best possible scenario. The current system can stand improvement in terms of low income affordability and access to service, and conservation programs for all customers.

Recommendation: The status quo has produced relatively low prices for most gas customers, but still has problems. One option is to continue with the existing system, making modifications to address the problems raised in these comments. It should not be scrapped unless there are clear gains for all customers and issues of equity, access and conservation are addressed.

b.) Pilot Projects

The report reflects PSC interest in testing small customer gas unbundling in a pilot, and states that CINergy is expected to make a proposal soon, based on a program in Ohio. The central question for any pilot is : what are you trying to find out? KEPC believes that a well designed pilot may be beneficial in gaining further understanding of the impacts of small customer unbundling.

The stakeholders had widely different views on the purpose and usefulness of a pilot. The LDCs questioned the value of such an effort, stating that pilots are not successful in replicating market behavior and that Kentucky can learn from the results of pilots in other states. While it is true that a number of residential gas unbundling pilots are taking place, there is not much in the way of results yet. Over thirty companies in sixteen states and more than 6 million customers are involved in these efforts. KEPC feels that results from other states, with differing prices, demographics and markets, will not provide information of real use for Kentucky. The parties agreed that any pilot conducted in the state should be as large as possible. The PSC should ensure that all suppliers are credit worthy and able to deliver gas as required. The Legislative Research Commission said a pilot could help determine if residential customers want choice of supplier, as well as help iron out implementation problems.

Pilots slow down the process of complete unbundling, and some LDCs are eager for the chance to set their affiliated marketing companies loose on small customers. This should not stop the PSC from conducting a pilot if it is seriously considering broad unbundling.

How can a pilot serve a useful purpose in Kentucky? First, it is not likely to indicate what prices will look like in the long term, or how the market will develop. However, a pilot can serve several functions:

* Allow time for a careful and deliberate approach
* Test implementation procedures, information exchange, etc.
* Determine customer interest
* Identify problems nobody thinks of in advance

How can pilot proposals be evaluated from the small customer viewpoint? MSB Energy Associates produced a "scorecard" critique of electric retail access pilot proposals for the Pennsylvania Energy Project this spring that rated utility proposals in that state as follows:[4]

* Consumer Friendly?
* Good Deal for Customers? ($ savings)
* Equitable Among Customers?
* Promote Competition?
* Good for the Environment?
* Support Universal Service?
* Reliable Service?
* Promote Economic Development?

The process of pilot design gives stakeholders an opportunity for discussion and debate,

[4]*Pennsylvania Utility Retail Access Pilot Critique*, MSB Energy Associates, Inc., Middleton, Wisconsin, May, 1997

and to learn more about the issues and mechanics involved. Basic design issues that need to be considered include the number of households, geographic area, number of competitors, limitations on affiliate suppliers, consumer protections, recruitment and public education, length of pilot, and evaluation process and criteria.

Recommendation: The Commission should encourage and solicit broad public input in the design of any pilot project and the development of evaluation benchmarks, rather than leaving any pilot initiative to the LDCs.

c) Broad Unbundling

Neither the Commission nor the legislature should proceed with broad unbundling at this time. There are significant issues that are deserving of further study, and a need for more broadly inclusive public education and participation in the debate over the future structure of gas and electric utilities, before a decision is made to embrace broad unbundling. Only if the risks to consumers can be eliminated and significant benefits, in terms of cost savings, environmental responsibility, and parity among classes of customers, could be assured, would such a change be considered in the "public interest."

d) Alternate (Incentive) Ratemaking

Alternate ratemaking is a pricing structure whereby captive customers are not charged based on the cost of service plus a reasonable rate of return on investment, but instead on how well the utility meets or fails to meet certain goals. The Commission would set the goals and in theory establish rewards or penalties based on performance. This would not necessarily save money for customers, but might in theory address areas of needed performance improvement.

KEPC views alternate ratemaking as largely a mechanism to avoid regulation of pricing and does not at present support such a proposal. If the Commission intends to give further consideration to some incentive program, any such program should provide real incentives that could benefit ratepayers, and not simply craft a way for utilities to avoid regulations that limit profits.

One area where an incentive may be appropriate is with respect to the recovery in rates for uncollected bills and collection costs. Since this recovery is built into the rates there is no incentive to reduce these costs. There are many options available to reduce collection and uncollectable costs, but no incentives for utilities to pursue them. LG&E, for example, is a utility with options available that have not been fully pursued. Uncollectable bills and higher collection costs are usually associated with lower income customers who may want to pay their bill in full, but lack the financial resources. This problem is complicated by the fact that many of these customers live in older housing that is poorly insulated. A community-based program in the LG&E service territory addresses these problems and also reduces LG&E's collection and uncollectable cost. The All-Season Assurance Plan is a comprehensive program that helps lower-income customers with bills and past arrearages through a combination of monthly monetary assistance, education, and social service assistance. This program has dramatically reduced late payments of these customers (and associated collection costs) and has helped these customers get out of debt with LG&E. While this program has been successful for about 1000 customers, it is not of sufficient size to be of help to all LG&E customers in this situation. While the program is successful and helps LG&E to reduce collection and uncollectables, there really is no incentive for LG&E to expand the investment in such a program.

Recommendation: Incentive ratemaking is good for customers only if performance standards are developed which reflect and place value on those things that customers care about, and only if real disincentives are actually imposed. KEPC is concerned that the captive customer may or may not see better service or lower prices, and does not support any alternate ratemaking which merely increases profit margins by moving away from cost-based ratesetting. KEPC cautions that if an incentive approach is pursued by the Commission, appropriate standards and benchmarks relating to performance in critical areas of concern to small customers, including lowering shut-off rates, conservation, reduction of collectibles and collection costs, must be included.

e) Additional Options: Consumercos and Community Access

Small customers could participate in a competitive marketplace through pools that would give them higher volume and greater market power, either through local government or through creation of "consumercos." The attached chart details over two-dozen forms that such buyer pools could take.

Recommendation: Mechanisms for customer aggregation should be fully studied by all parties, and be reasonably accessible and available any unbundling scenario, including any pilot programs.

Table: Forms Of Buyer Aggregation

Geographic	
Type	**Description**
Municipals and Co-ops	End-users of all classes jointly own distribution system, sometimes transmission and generating capacity, either directly as members of co-ops or indirectly as citizens of a municipality. Entity purchases energy for distribution to all customers in territory.
Muni-Lites	Municipal owns small part of distribution system, such as meters. Buys wholesale energy for distribution to all end-users within municipal boundaries. Pays owner(s) of transmission and distribution systems for moving power through.
Consumer Service Districts	A group of towns, counties, or other municipal entities and/or co-ops forms a larger entity that purchases wholesale power for all end-users within the district's boundaries. Pays owner(s) of transmission and distribution systems for moving power through.
Franchised Service Territories	A municipality does not own any part of the distribution system, but bids out the rights of way for poles, wires, etc., in exchange for fees, certain conditions of service. In retail competition scenario, the municipality can either purchase energy for end-users within its boundaries and the fee it owes for distribution is offset by the franchise fee, or enter into an agreement to allow the distribution company to sell energy within its boundaries in exchange for a fee.
Neighbor-hood Groups	End-users within a small geographic area, such as a city neighborhood or a rural section of a county, form a group that jointly purchases energy on the wholesale market and pays the owner(s) of transmission and distribution for moving power to them.

Quasi-Geographic	
Type	**Description**
Employment-Based Groups	An employer or labor union shops for energy supply on behalf of workers. Can be based at one site or scattered sites served by the same company or union.
Co-ops	Existing agricultural, food, and other buyer co-ops can provide energy shopping services for their members as well. Members are generally scattered within a set area.
Low-Income Groups	Low-income customers participating in financial assistance, energy efficiency, public housing, or other programs serve as a group for energy shopping purposes.
Institutions	Schools, hospitals, government agencies, churches, nonprofit organizations, and similar institutions form a consortium to shop for energy supply.

Nongeographic	
Type	**Description**
Power Clubs/ Co-ops	End-users jointly purchase wholesale energy and pay the owner(s) of transmission and distribution for moving power through. Co-op is a nonprofit. Cost to co-op member is wholesale price plus transmission and distribution fees and co-op administrative costs. Co-op membership is defined by nongeographic factors, *i.e.*, membership in an association.
Subsidiary Power Clubs	As a service to its members, an association forms a subsidiary that purchases wholesale energy and arranges for transmission and distribution. The parent organization may or may not collect more than its administrative costs.