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JON WELLINGHOFF

What Do “436,” “436-A,” “451,” “311,” “7(c)” Mean to the Residential Gas Consumer

INTRODUCTION

The answer is “*NOT A DARN THING!*” Consumers throughout the Western United States, including those in Nevada, my State, are more than a little confused about changes in natural gas service and the prices they pay for that service. My intent in this article is to provide you with the consumers’ perception of the problem, the perspective from which that problem has been explained to the consumer to date, the consumer’s bottom line regarding utility services and costs, and finally, to suggest some utility and regulatory actions that can help satisfy consumers’ concerns.

Before I launch into the turbulent sea of natural gas policy, let me explain my qualifications to speak from the consumer perspective and outline the general duties of my office. Consumer advocate’s offices are fairly numerous, with approximately forty-two states having offices with functions similar to the Nevada office. The Nevada office was created in 1981 by our State Legislature¹ for the purpose of representing utility ratepayers in all matters that affect their cost and quality of service. We pursue that representation before state agencies in Nevada, the courts and federal regulatory and congressional proceedings.

I was appointed as Nevada’s first consumer advocate in 1981. Over the past five years our office has represented the utility ratepayers in our state in hundreds of proceedings before the Nevada Public Service Commission, the Federal Energy Regulatory Commission and other state and federal bodies. That representation has resulted in an estimated saving for consumers of the State of Nevada in excess of three hundred million dollars. In the course of our work, we have represented the consumers’ interests in numerous natural gas proceedings including rate cases, 436 certificate filings, new facility certification proceedings, and purchased gas adjustment cases. This representation has been both at the state and federal level.

THE CONSUMER PERSPECTIVE

With this background, let me turn to the consumers’ perception of the

1. NEV. REV. STAT. §§ 228.010-.400 (1981).

problem regarding natural gas rates and services. The problem is one of a lot of shouting with little perceived action. Consumers see almost daily stories in their local newspapers and in national publications such as the *Wall Street Journal* that disclose radical changes taking place in natural gas policy. Consumers also see national news touting the dramatic drop in wellhead prices of oil and gas—in some cases as much as fifty percent—in the last eighteen months. Despite this wave of seeming change, until recently the consumers' rates changed little and service remained the same.

Let me provide three examples that illustrate consumers' perception of problems in the natural gas industry. The first is from an article that appeared on October 21, 1986, in the *Washington Post*.² The article describes a report of the Citizen Labor Energy Coalition, a Washington consumer group, that charges that nationwide declines in natural gas prices have brought big price breaks to industrial customers, but have been a bust to residential customers. The article goes further to charge that residential customers should have received an additional three billion dollars in reductions on their utility bills in the last two years from declining natural gas prices but such reductions went primarily to industrial and large commercial customers instead. The article supports these allegations with data that shows that prices to residential customers in the District of Columbia fell five percent, while prices to commercial customers fell nine percent. In Maryland, prices for natural gas to industrial customers fell sixteen percent, twelve percent to commercial customers and only eight percent to residential customers. And in Virginia prices for natural gas fell sixteen percent to industrial customers but only three percent to commercial customers and one percent to residential customers. When asked to defend these prices, a spokeswoman for Washington Gas Light Company replied that it was necessary to cut commercial rates sharply so "commercial customers who use other fuels don't leave the system."³

Michael Foley, Director of Financial Analysis for the National Association of Regulatory Utility Commissioners in Washington, defended the practice of giving substantial cuts to industrial customers by stating, "Our response is you've got to give an industrial customer a price break or you'll just lose the industrial customer altogether."⁴ Similar arguments were made by representatives of other regulatory agencies and utilities in Maryland, Virginia and the District of Columbia.

2. *Natural Gas Price Drop Brings Mixed Results*, *Washington Post*, Oct. 21, 1986, at C1, col.

3.

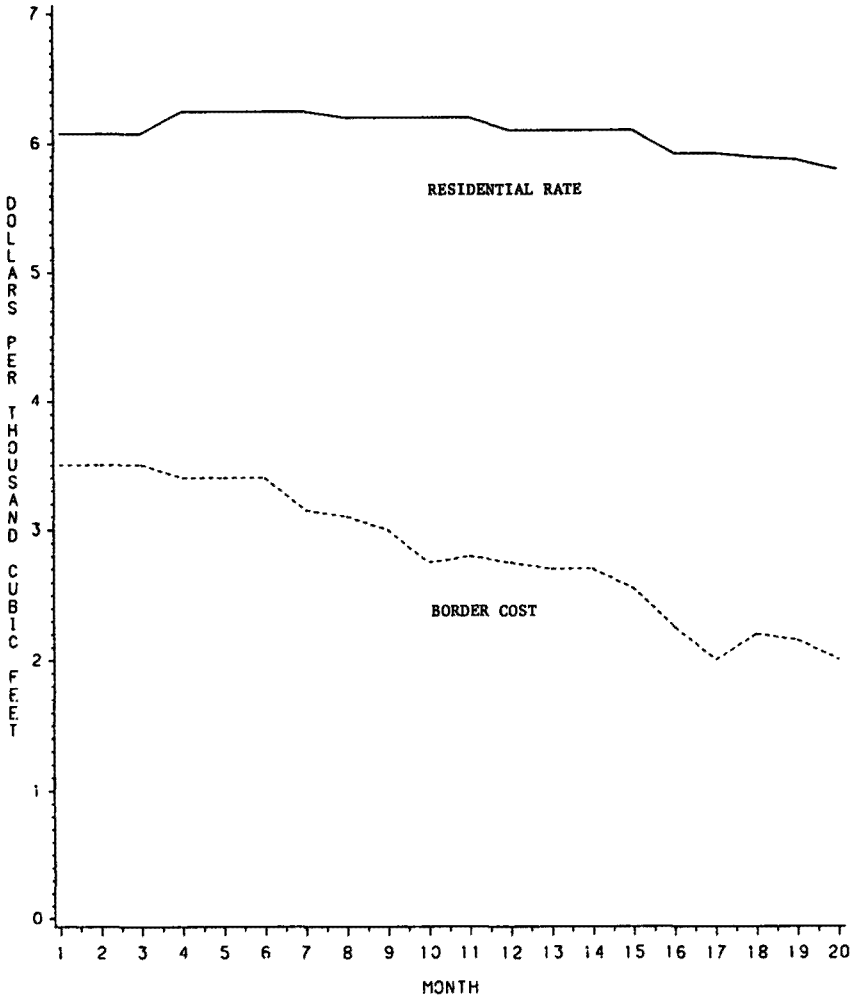
3. *Id.*

4. *Id.*

These examples make clear that consumers on the national level are receiving information that substantial price breaks are occurring in the natural gas industry but those breaks are not being passed through directly to the residential consumers.

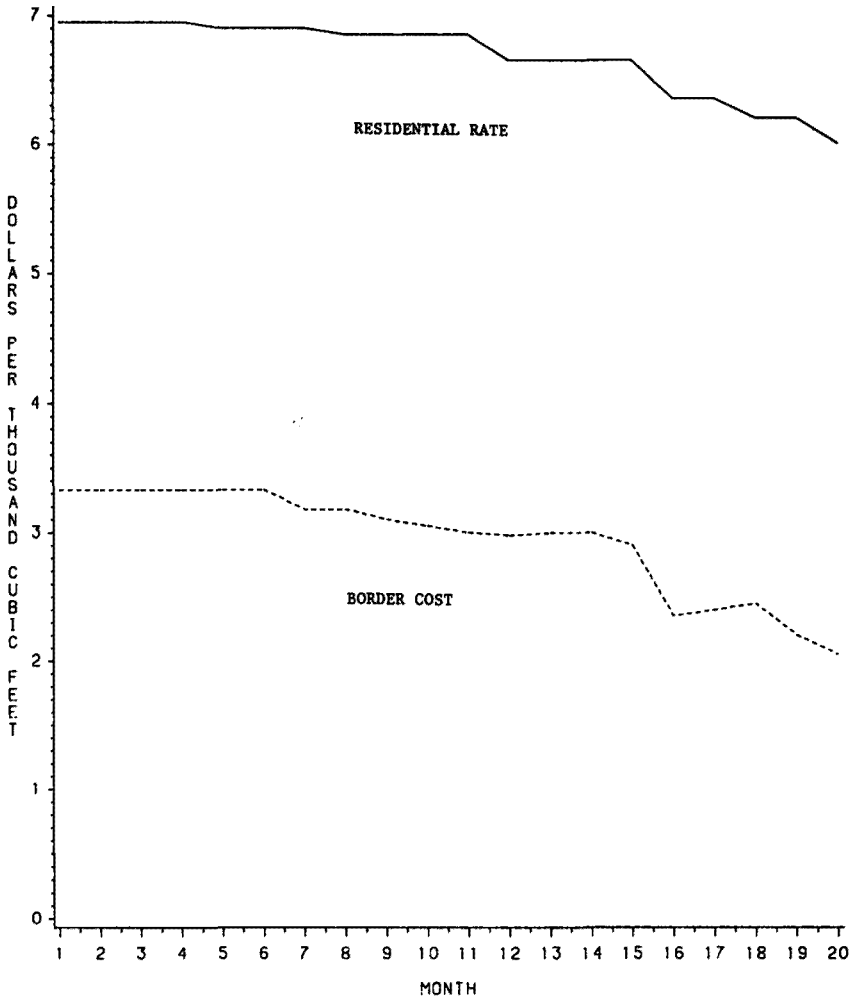
A second piece of evidence is drawn from data showing natural gas prices in Nevada over the last eighteen months. Figure 1 and 2 depict

FIGURE 1
SOUTHERN NEVADA NATURAL GAS PRICES
AVERAGE BORDER COST VS. AVERAGE RESIDENTIAL RATE



MONTHS: JANUARY 1985 (1) TO AUGUST 1986 (20)

FIGURE 2
NORTHERN NEVADA NATURAL GAS PRICES
AVERAGE BORDER COST VS. AVERAGE RESIDENTIAL RATE



MONTHS: JANUARY 1985 (1) TO AUGUST 1986 (20)

the average price paid by the residential consumer in the last eighteen months to their local gas distribution company in the northern and southern service territories of Nevada and the price paid by the intrastate gas pipeline company at the border over the same period. The figures show that there is often a considerable lag between decreases in border prices and subsequent decreases in residential prices in Nevada.

Figure 1 and 2 also show another interesting phenomenon. Despite the fact that there has been a thirteen percent and five percent reduction in average residential gas costs in the north and south respectively over the period, there has been an actual increase both north and south in the differential between border prices and residential average costs. The differential increased ten percent in the north and thirty-nine percent in the south even though there was a much more active spot market in the south. This may indicate that residential consumers in Nevada are not reaping the benefits of open gas markets and pipeline access.

Finally, the following story emphasizes consumers concern and frustration over the natural gas situation in Nevada. Up until about six months ago, no significant reductions were evident in the residential natural gas rates. But as long as eighteen to twenty months ago, significant information was available in national publications that indicated major reductions in the price being paid to producers for natural gas supplies. About this time, phone calls were received in my office from a very wealthy northern Nevada investor who happened to have significant investments in oil and gas production wells in Oklahoma and Texas. He indicated that he knew there were large volumes of gas in Oklahoma and Texas being sold for less than \$3.00 per mcf and that in some instances producers were having trouble selling gas above the \$2.50 range. He noted that the current Northern Nevada residential gas rate selling for over \$6.80 per mcf and wanted an explanation of the differences between wellhead prices and residential gas rates. On the face of it, there did seem to be a gaping disparity between the prices being paid to producers and the ultimate price being paid by the residential end-user in Nevada.

Over a period of a year, this gentleman called at least twice a month pointing out information in the national press that indicated that the disparity between the price at the wellhead and the price that the residential consumer paid was continuing to grow. In part because of this consumer's persistence and because of the Consumer Advocate's responsibility to assure that Nevada ratepayers pay the lowest rates possible, an investigation was undertaken to determine why Nevada residential rates were so far above the current producer cost.

The cost of supplies of natural gas was dropping rapidly from mid-1985 to the first quarter of 1986. This was evident from data provided by the Energy Information Agency and other sources.⁵ Northern Nevada also receives a substantial amount of gas from Canada and the Canadian government was dropping the border price of gas during this time. From our investigation, there seemed to be a bottle-neck in price reduction

5. ENERGY INFORMATION AGENCY, U.S. DEPARTMENT OF ENERGY, NATURAL GAS MONTHLY: FEBRUARY 1987, DOE/EIA-0130(87/02) (Apr. 1987).

between the producer, supplier, and the end-user. The source of this disruption in the flow of price reductions appeared to rest at the doorstep of the transmission pipeline companies. There seemed to be either corporate or regulatory blockades which were preventing price reductions from coming through to residential end-users.

For an individual residential gas customer to understand the complexities of these problems, it would be necessary for them to wade through a myriad of what I refer to as "buzz numbers" (for example, Order 436, or Section 311) and "buzz words" (for example, "common carriage" or "open access").⁶ Residential consumers would understandably shake their heads and wonder what language these terms and numbers came from.

WHAT CONSUMERS WANT

What does the consumer want? It's relatively simple. Consumers are interested in reliable energy services at the least possible cost. Consumers do not use or consume electricity for the sake of using electricity. They are interested in the services that those energy sources can provide to them as consumers. Residential consumers are impacted by these energy services in two ways. The first is the direct impact on an end-user of natural gas to heat their homes, to provide energy for cooking and water heating and other services that are best performed by gas appliances in a residential setting. The second impact stems from the indirect effect of gas prices on prices of electricity produced by a gas fired generation. Given their focus on these direct and indirect impacts and the consumers' overall desire to have natural gas services provided at the least possible cost, it should not be surprising that consumers are largely unconcerned with the complexity of open access, Order 436, gas abandonment, Order 451 and other nuances of the regulatory process.

A CONSUMER ORIENTED POLICY

Such regulatory changes as Order 436 and Order 451 seem to be an established part of the future of the regulatory changes which will impact gas pricing to residential consumers in the future. Nevada's two main transmission pipelines, El Paso in the south and Northwest Pipeline in the north, either have already or are undergoing certification under the 436 process. Despite the complexities involved, these are events which cannot be ignored by consumers or the consumer advocates. One does not have to be concerned with issues such as transportation by-pass to large industrial and commercial customers and transportation rates to local

6. These and other terms peculiar to the natural gas regulatory debate are defined in the SUPPLEMENTAL GLOSSARY appended to this volume.

distribution companies to ensure that residential customers are treated equitably with respect to the reduction in natural gas bills. As can be seen from Figures 3 and 4, projections of natural gas costs in 1986 dollars for Nevada over the next ten years show an initial decline and then remain relatively stable for the period. If prices remain relatively stable over that period, residential customers' goals of maintenance of reliable gas services at the lowest possible cost can be achieved with a policy involving minimal regulatory interference.

FIGURE 3
NORTHERN NEVADA NATURAL GAS PRICES
ESTIMATED AVERAGE BORDER COSTS THROUGH 1996

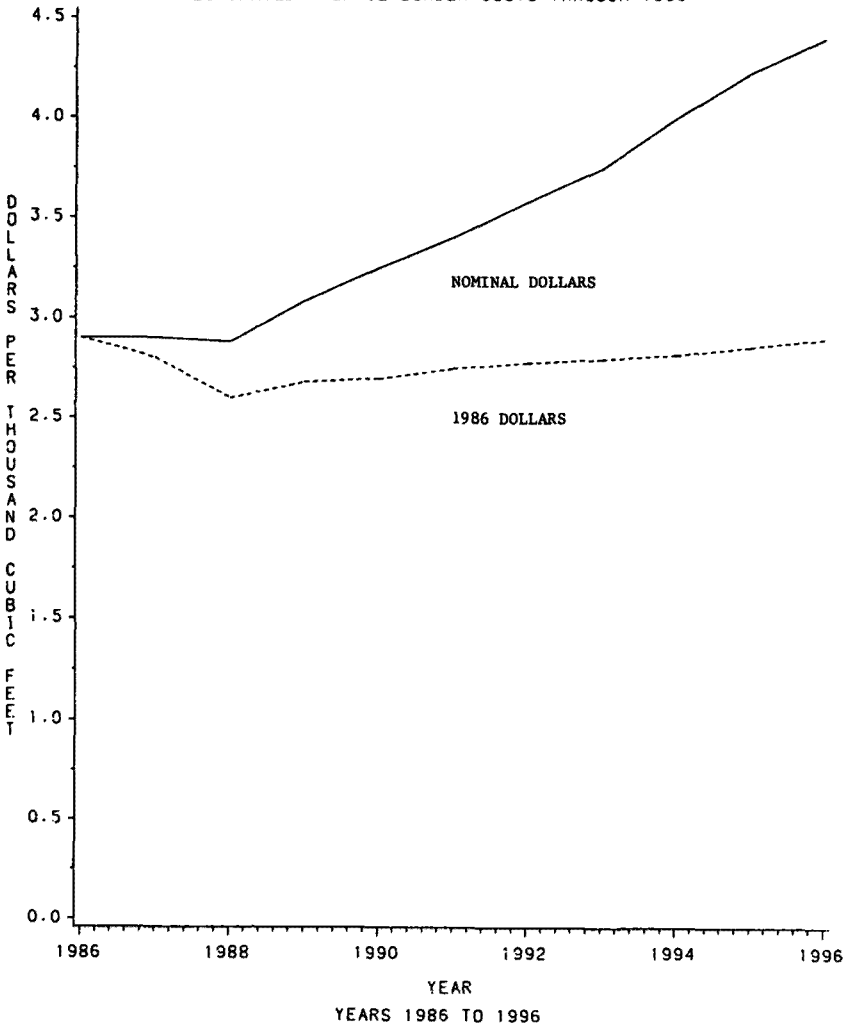
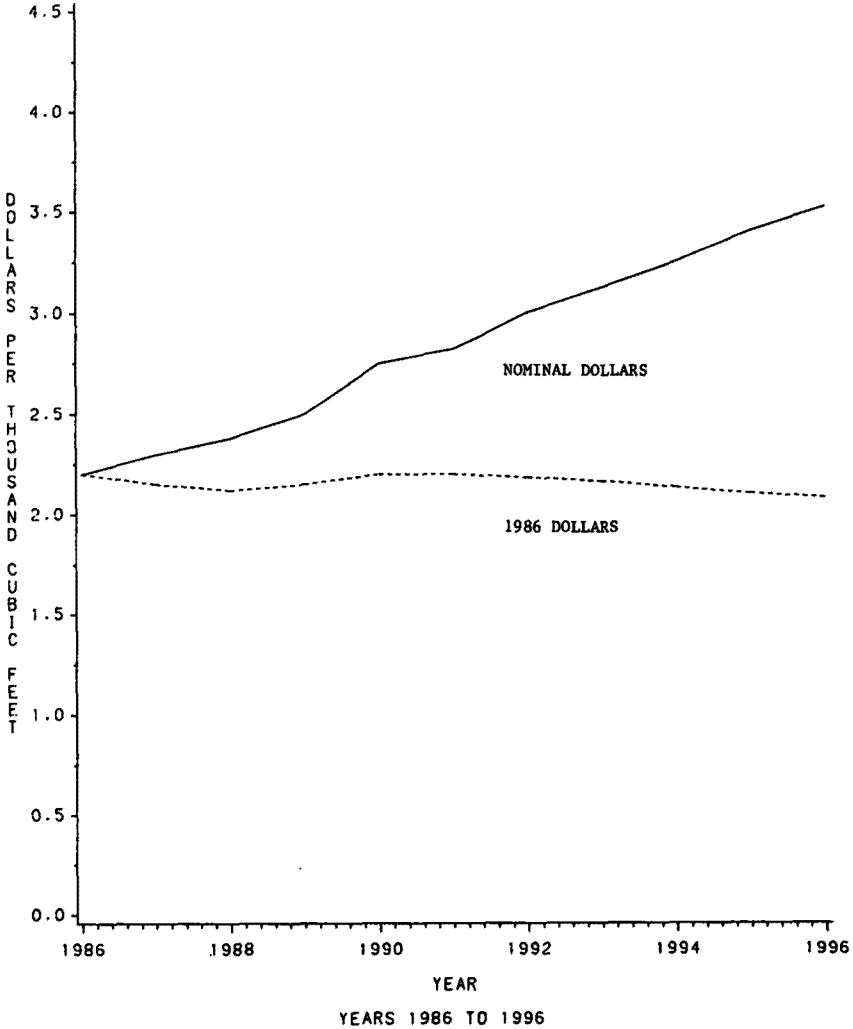


FIGURE 4
SOUTHERN NEVADA NATURAL GAS PRICES
ESTIMATED AVERAGE BORDER COSTS THROUGH 1996



The minimal regulatory framework should be established in the following manner. First among the regulatory activities which will be necessary to guarantee residential gas customers a fair break under changing federal regulatory policies is a state monitoring system to ensure that local distribution companies are maximizing their efforts to utilize new federal regulatory provisions such as 436 and 451 to obtain gas from sources that provide a reliable supply at the least possible cost. This will

be necessary at the state level because under 436 the burden of defending the prudence of gas purchases will shift from pipelines accounting to the Federal Energy Regulatory Commission to the local distribution companies who will have purchases reviewed by state regulators.

Nevada has a model for this type of utility planning approach. It is called least-cost "utility resource planning" and it has been successfully applied to Nevada's electric utilities since 1983.⁷ Such techniques need to be adopted universally and require oversight to ensure residential consumers fair representation in the process.

Least-cost gas supply planning by utilities and monitoring by state regulators will be necessary not only for local gas distribution companies but also for electric utilities that generate with gas and alternative fuels. In the case of Nevada, it has been found that local electric companies are not always aware of their options with respect to purchasing gas and obtaining transportation for gas over interstate and intrastate transmission pipelines at the least cost. Recent research on this issue suggests that, for regulated firms like electric utilities, sufficient incentives to keep costs at a minimum will not be present.⁸ For these reasons, state regulators will have to establish procedures and checks which monitor both the local gas distribution companies and the electric companies to see to it that they take advantage of these new procedures and seek out the best and cheapest sources on the independent markets so that residential consumers may fully benefit from competitive gas markets.

Next, state regulators must monitor very closely transportation by-pass and proposed incentive rates for potential fuel switching customers. The fuel switching incentives issue is a particularly sensitive one for residential gas customers. Certainly, to the extent that local distribution companies are by-passed by their industrial and commercial customers through open access marketing schemes that are and will become available under Order 436 and regulatory variations to that Order, there may be substantial pressure placed on residential rates to increase. Local distribution companies should be encouraged by regulators to work with their larger customers to ensure that significant losses in the distribution company's margin on its fixed costs are not incurred due to by-pass. Reasons for such special treatment either for by-passers or fuel switchers must be fully and carefully explained, however, to the residential customer.

Regulatory and corporate efforts to maintain equity for the residential customer must not stop with mere explanations. The potential for such

7. For a recent article that describes the techniques for least-cost gas supply planning, see Cull and Soutup, *Least-Cost Gas Supply Planning Techniques in a Competitive and Regulatory Environment*, PUBLIC UTILITIES FORTNIGHTLY (Oct. 1986).

8. See, e.g., H. LEBENSTEIN, *BEYOND ECONOMIC MAN* (1976).

by-pass and fuel switching resulting in shrinking margins for local distribution companies can be offset in part by regulators giving local distribution companies the freedom to expand in markets that have been historically unavailable from either an economic or technological standpoint. Such freedom to pursue new markets could also produce revenues which could be utilized to offset lower incentive rates that may be necessary to minimize the total amount of transportation by-pass and fuel switching that occurs on a local distribution system. This freedom includes new marketing avenues such as gas distribution companies selling electric energy efficiency to its commercial and even residential sectors.

Gas companies, either in competition in their service territories with electric companies or as part of combination gas and electric companies, can increase their market share through "foot in the door" activities such as marketing electric energy efficiency, and all customers and shareholders can potentially be benefited. The residential gas customers benefit by additional sales on the gas system which maintains the local distribution company's margins and relieves the pressure to increase residential rates. Industrial and commercial gas customers are served in the same way as residential gas customers if they remained on the local distribution system. Those customers that either have alternative fuels or are looking to bypass the system are possibly benefited by incentive rates which could keep them on the system. Further, the residential electric customers are benefited to the extent that they are in a growing electric service territory that anticipates the need for future electric generating resources to meet the future demand growth in the area. The benefit is due to the delay in the need for the electric company to spend significant capital investment in new generating facilities. Thus the present worth of future revenue requirements for the electric system will be minimized and average electric bills will also be minimized. Commercial and industrial electric customers benefit in a similar manner. By maintaining margins for the gas company and reducing capital expenditures for the electric company the stockholders of each will also benefit.

As a specific example, consider the following scenario. The local gas distribution company goes out to a number of its small retail commercial establishments in its service territory. It agrees to retrofit all the incandescent and inefficient fluorescent lights in those establishments with new efficient fluorescent lights and ballasts at no up-front capital costs to the retailer. Significant data exists which indicates that up to eighty percent of lighting expenses can be saved with new efficient equipment. The cost of the retrofits will be paid for by shared savings of the reduced electrical bills which result from the retrofits. At the same time the gas company conducts these retrofits, it asks the retailers to allow its technicians to

inspect its air conditioning equipment to determine the condition of that equipment and its remaining useful life. From these inspections it is determined that a third of the establishments have electric refrigerant air conditioning that will require either major maintenance or replacement within the next three years. Based upon the overall reduction in cooling load for the establishment due to the reduction in heat output by replacing inefficient lights with efficient lighting retrofits, the gas company can show those retailers with failing electrical air conditioning that there are substantial benefits to be had from the current replacement of that air conditioning with substantially down-sized gas absorption chillers. Again, the cost of this equipment is paid for on a shared savings basis and the local gas distribution company is provided a reasonable return on its investment. The local gas company makes a profit on all the equipment it installs and the company also increases its overall sales of natural gas through installation of the gas absorption chillers.

The electric company, on the other hand, does lose immediate revenues from the reduction in electrical energy consumption in the short-term. But, because Nevada and most of the western United States is a growing service territory, these losses will be quickly recouped from additional new customers that the company is able to serve without any investment in new facilities or purchase of any additional supplies of electrical energy. Some western utilities, notably San Diego Gas and Electric, are well along in implementation of this strategy.

These programs can do more than reduce customer bills and increase system gas sales to the commercial sector. They can also add sales to the residential sector, for example, last summer Montana Power ran a pilot gas sale program with the goal of becoming the lowest-cost energy supplier. The company offered its gas customers a \$200 one-time cash payment to switch from an electric water heater to a gas heater.

As a final regulatory solution to ensure that future natural gas policy treats residential gas customers fairly and equitably, regulators should consider incentive rates for potential residential fuel switchers in the same manner and to the same extent that such considerations are now given to commercial and industrial by-passers or fuel switchers. Regulators and LDC should recognize that there are substantial numbers of natural gas space heating customers who by-passed the natural gas regulatory wars by plugging in that old American standard, the wood stove. There are substantial numbers of such customers in northern Nevada and other rural areas. Given current reductions in gas rates, there are significant economic incentives to switch from wood to gas. But old habits are hard to break. Furthermore, extensive use of wood stoves in some locales have resulted in significant levels of winter air pollution that in recent years has reached

dangerous levels. Local distribution companies that provided dual fuel residential customers with incentives to come back to natural gas would both improve their sales, and provide a substantial service to the community by reducing air pollution. Precedent for such residential incentive rates has already been set in the electric utility sector by Montana Power, which is currently offering a space heating incentive rate for customers who have dual electric and wood heating capabilities.

In sum, although residential consumers continue to be confused and frustrated over natural gas prices, they understand that reductions do flow to them eventually. Now that we are entering a period of shake-out with federal regulatory policies, it is hoped that a stabilization of gas prices will ensure that residential customers can continue to enjoy reduced gas prices. Along with these changed policies for transportation and treatment of various types of gas, residential customers ask that they be treated in a fair and equitable manner to ensure that the reductions seen at one end of the pipeline are indeed passed to those individual residential consumers at the other end of the distribution system. All that the consumer is asking for is reliable gas service at the least possible cost.