

# NATURAL GAS MARKET DESIGN

## TASK FORCE

### REPORT TO THE ONTARIO ENERGY BOARD

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June 16, 1998

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June 16, 1998

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Attention: Floyd Laughren, Esq.  
Chair

Dear Mr. Laughren,

On behalf of the Natural Gas Market Design Task Force, I am pleased to submit a report which responds to its terms of reference and summarizes its deliberations over the last month and a half. The work has been challenging, collegial and fruitful. Board staff have been extremely helpful throughout the process.

In recent years there has been a global trend towards deregulating sectors formerly characterized as natural monopolies. Systems and structures, be they market or regulatory, rarely move smoothly from one state to another. Something old must come apart in order for something new to come together. But until there is a clear grasp of the next "stable state" (as opposed to a clear picture of the one to be lost) the uncertainty and dislocation poses significant challenges for policy makers. The fact that similar transformations have occurred or are occurring elsewhere provides little comfort to those directly affected.

One way governments often deal with this tension is by the maintenance of a facade of progress and problem solving. If we are not solving issues, we must at least give the appearance of progress by moving on to the next batch. This, in turn, often leads to a search for "quick fixes" and the myth of "once and for all" solutions.

The Task Force has tried to avoid succumbing to these tendencies. Given the time and resources available, it has made substantial progress in narrowing issues and options. However, its work is far from conclusive and is intended to serve as the basis for a more intense and extended effort through a relatively brief transition

period to full retail “unbundling”. The Task Force believes that such an effort **can best** occur in time, where the situations being addressed will change under (or as a result of) the very processes of deliberation. As is suggested in the Report, and contemplated in the legislation tabled last week, such an effort should be coupled with the Board’s utilization of more flexible regulatory instruments.

While the Task Force achieved consensus on basic principles concerning most of the issues put to it, the resolution of one will require some process for non-consensual Board direction. Such a mechanism must be agreed upon and in place before the Task Force can undertake the additional work it proposes.

This is not to suggest a lack of commitment to action. As is evident in the report, the Task Force shares with the Board a vision of the desired outcomes, and a sense of urgency. It is prepared to assume a leadership role in co-ordinating the formulation of advice for the Board concerning detailed structural requirements and transitional concerns. In any event, it stands ready to be of whatever assistance it can in facilitating and expediting the Board’s decision-making during the transition process.

Sincerely,

Edward J. Waitzer

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# I INTRODUCTION

## A. BACKGROUND

Well over a decade ago, the Ontario Energy Board (the “Board”) expressed its support for the development of a competitive market for natural gas and moved expeditiously to facilitate the development of a competitive direct purchase market. As a result, Ontario took a leadership role in developing the framework for a competitive and reliable market in the province for natural gas. While, initially, participation in the direct purchase market was limited to large volume consumers, it has gradually expanded to include a substantial proportion of retail customers.<sup>1</sup>

Currently direct purchase arrangements in Ontario serve in excess of 900,000 end users and represent over 75% of total LDC throughput. To date, however, historical legislative constraints have impeded full realization of the benefits (and scope) of competitive service offerings.

To this end, during the course of the last several years, the Board has led an extensive consultative process focused on completing the transition to a regime in which the sale of gas and other non-monopoly functions would be conducted on a competitive basis. The initial impetus was a series of consultations in late 1995 and early 1996, which led to the Board’s Ten-Year Market Review of Natural Gas Deregulation (the “Market Review Report”)<sup>2</sup>. In the Market Review Report the Board indicated its belief that “a fully competitive gas commodity market will be more efficient than a regulated market and that, accordingly, where an efficient and equitable market is possible and sustainable, the Board believes that customers can

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<sup>1</sup> Retail customer or retail end user refers to the OEMA definition, which includes any customer consuming less than 50,000 m<sup>3</sup>/year.

<sup>2</sup> September 27, 1996.

best be served by allowing the market to operate freely, without the need for economic regulation”.

The Market Review Report identified a number of issues which the Board felt merited further consideration by a working group. Such a group was organized in the fall of 1996 and issued its report, “Toward a Fully Competitive Natural Gas Commodity Market in Ontario” (the “Working Group Report”) on May 31, 1997. The Working Group achieved consensus as to (i) the need for legislative reform to remove impediments to gas commodity title transfer in Ontario as soon as possible and (ii) the desirability of substituting full and effective competition for Board regulation wherever possible. With respect to certain transitional issues, however, the Working Group could not achieve consensus. It rather identified and expressed divergent views concerning how, when, and under what circumstances the Province and/or the Board should proceed to allow the local distribution companies (“LDCs”) to exit the merchant function.

Following receipt of the Working Group Report, the Board undertook a further consultative process to assist it in providing advice to the then Minister of Environment and Energy in respect of potential legislative changes. This legislative review consultation process, conducted under Board File No. E.B.O. 202, proceeded through the summer and fall of 1997 and resulted in the Board’s Advisory Report to the Minister of Energy, Science and Technology on the Legislative Change Requirements for Natural Gas Deregulation (the “Report on Legislative Change”) dated December 16, 1997. In the Report on Legislative Change, the Board concurred with the conclusion of the Working Group Report that the removal of impediments to gas commodity transfers will facilitate a move to full retail access and competition in the Ontario natural gas commodity market. The Board also indicated its view that the public interest would be best served by a “managed process” to encourage market restructuring while protecting gas customers during the transition. The Board sought to identify the key features of such a transition.

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In addition to outlining the direction of legislative amendments intended to encourage restructuring of natural gas markets towards enhanced competition, while ensuring customer protection, the Board suggested a number of “next steps”, including the establishment of a Market Design Task Force (the “Task Force”) to address certain issues. On March 19, 1998 the Board sent to all E.B.O. 202 participants a letter outlining a proposal to establish such a Task Force along with a list of issues to be examined. After considering comments received on the proposal, on April 17, 1998 the Board sent to all E.B.O. 202 participants a list of Task Force members and issues which the Task Force was to be asked to consider. The Task Force first met on April 20. By May 7, it had developed a work plan, refined the issues list and engaged a facilitator to assist in its deliberations and the drafting of its final report. By letter of that date a work plan, terms of reference and amended issues list were circulated to all E.B.O. 202 participants. A copy is attached as Appendix A.

The Task Force met as group for ten full days from late April to early June in order to prepare and submit this report. Additional work, including informal consultations with other interested parties, was undertaken by individual Task Force members and the facilitator.

## **B. CONSENSUS ACHIEVED**

The objective which the Task Force set for itself was to focus on achieving consensus, where possible, and providing the Board with specific advice as to the implementation of preferred policy options. Hence, for example the Task Force achieved substantial agreement on the merits of proceeding towards the “Discussion Model End-State” postulated in the Working Group Report and considerably narrowed the range of views concerning elements of a model for competitive sales of natural gas. The Task Force’s specific operational recommendations are discussed later in this Report.

Perhaps as important as these issue specific proposals is the broad consensus achieved within the Task Force as to the merits and scope of further deregulation and as to the immediate need to begin to address the detailed issues of designing and implementing the requisite market infrastructure. It is recognized, within the Task Force, that there are a host of issues it has not had the time to conceive of and articulate clearly, let alone resolve, given the time and resources available and the uncertainty as to the precise nature of the proposed legislative reform, and, more broadly, how markets will evolve. There is a shared vision of the desired outcome and a shared will to continue to address structural requirements and transitional concerns with a view to expediting the process.

The Task Force is of the view that burner tip sales in Ontario and “unbundling” in the context of properly functioning competitive markets will generate benefits for customers. Essentially, “unbundling” is the separation and separate offering of distinct LDC service and product components, such that customers may elect to purchase from the LDC only those services that they require or, where a service is available from third parties, to purchase that component from those third parties. In the Task Force’s view, the principal advantages of unbundling are threefold. Firstly, it should promote competition amongst providers of services and, as a result, increase customer choice and flexibility. Secondly, separating competitive services from the monopoly functions of the LDCs should reduce the potential for cross-subsidization of competitive services with ratepayers funds (so that the LDCs can operate in a more market-oriented environment). Finally, as services are unbundled and subject to competition, the need for and degree of traditional regulatory oversight should diminish.

Some of these benefits have already been realized, primarily by industrial and commercial end users, as a result of partial restructuring. Timely reform of the regulatory framework is essential to enable open and competitive markets to evolve and respond to small volume retail customer preferences, and to avoid distortions in

consumer choices as between alternative sources of energy supply as well as other service providers. Failure to do so in the face of similar efforts in other jurisdictions could result in declining competitiveness and slower economic growth in Ontario.

In broad terms, the focus of the Task Force's deliberations was on transitional issues. Here, again, consensus on basic principles was achieved. The Task Force is of the view that undue delay or avoidance of regulatory reform, at this juncture, is more likely to give rise to (than mitigate), transitional costs for all stakeholders in Ontario's natural gas sector. While existing commitments should be honoured (or managed until they can be wound down), the best way to deal with "left-overs" from the current, regulated market structure is to promote effective competition and informed customers.

With respect to the development of new processes and practices, the Task Force commends the Board's leadership role in encouraging and facilitating market participants to plan ahead with a clear sense of public policy objectives and direction and with timely and effective processes for resolving public policy concerns as they arise. Such leadership (and oversight) are likely to be more effective roles for the Board to play than would be efforts of the Board to micro-manage market activity or, indeed, the transitional process itself.

This is not to suggest that a restructured natural gas industry will not require regulation. The challenge, rather, is to define the boundaries, explore new instruments, seek new ways to interface regulated and unregulated activities and focus on the outcomes from (rather than detailed inputs to) regulation.

### C. CONSTRAINTS

The Task Force operated under severe time and resource constraints. Task Force discussions were wide-ranging and often iterative. As certain issues were

resolved, others were revisited. This reflects the complexity and inter-relatedness of the issues considered.

In advancing normative recommendations, the Task Force assumed that there will be immediate action to remove legislative impediments to title transfer and that further deregulation is likely to be a “managed process”, with substantial retail unbundling (of transport, storage, load balancing, billing and other non-monopoly services) unlikely to occur before the 1999 rate process (for implementation in fiscal 2000). The Task Force did not have an opportunity to carefully review the proposed legislation tabled in the Legislature on June 9. This might be one of the initial tasks in the context of the continuing process recommended by the Task Force later in this report.

Given the constraints it was operating under, rather than compromising the integrity of its process or the quality of its recommendations the Task Force limited its aspirations in at least two other significant respects.

Firstly, consultation was not as complete or systematic as the Task Force would have chosen. While a genuine effort was made to take into account the known views of various constituencies (most of which were represented on the Task Force and, in any event, have made their views known in the written record of the last several years’ consultative processes), no formal consultative process was undertaken in connection with the preparation of this Report. Time did not allow for such an effort. While the Task Force believes that this Report is reasonably well balanced and, at a policy level, reflects recommendations which will have broad industry support, there will be a need for further industry input. This should be elicited primarily at the technical subcommittee level, as described later in this report.

Secondly, the Task Force did not attempt to achieve “closure” on issues except where there was high level of consensus for doing so. The Task Force sought

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to “do the best it could” to be of practical assistance to the Board, given the time and resources available to it. As is discussed later in this report, some expedited mechanism for Board direction, in the absence of industry consensus, will be essential to take the Task Force’s work to the next suggested level.

Subject to this prerequisite and mindful of these limitations and of its strong view that ongoing work to resolve transitional issues must be undertaken expeditiously and in a collaborative manner, the Task Force proposes its own continuation (or the establishment of a similar stakeholder advisory mechanism), without presuming to identify its continuing membership. Assuming the Board determines that it would be helpful for the Task Force to continue this work, one of the Task Force’s major tasks would be to constitute and co-ordinate the efforts and output of technical subcommittees dedicated to specific, specialized work, both to “flesh out” the Task Force’s recommendations and, on an ongoing basis, to identify and facilitate the resolution of specific operational issues that will arise as markets evolve. Such an ongoing advisory mechanism should better enable the Board to navigate through an intense and critical policy-making process in the coming two years and, hopefully, lead to an effective unbundling program with the least cost and fewest resource requirements.

## **II PRINCIPLES AND CHARACTERISTICS OF THE STANDARD SERVICE OFFERING**

### **A. BACKGROUND**

In the Report on Legislative Change, the Board articulated problems associated with system gas and suggested the development of a Standard Service Offering (“SSO”) as a way of resolving a number of these problems. The Board was of the view that the difficulties associated with the current cost-based, regulated supply (“system gas”) necessitate an interim redefinition, rather than elimination, of

that service. The Task Force concurs that this would be desirable, providing the transition costs for such temporary improvements are not unduly onerous.

The Board suggested a number of objectives for such an SSO, including providing a benchmark against which retail customers could compare marketers' prices and quality of service and a safeguard to consumers in the event that the market does not develop as anticipated. The Report on Legislative Change noted that "When the appropriate market conditions exist, the Board should also have the authority to order the cessation of the SSO or any of its elements by the LDC if these functions could effectively be provided by the competitive retail market." The Task Force was asked to consider and make recommendations concerning principles and characteristics of the SSO.

## **B. PRINCIPLES**

In considering the potential merits and characteristics of an SSO, the Task Force made a number of assumptions. As noted above, it assumed that approved unbundled retail rates are likely to be available in 2000, as per the timetable outlined in Appendix B to this report. It also assumed that retail customers will require a LDC supply option with cost based pricing for some transition period. Finally, for reasons discussed below, it assumed that the buy/sell mechanism should be phased out through the transition period.

The Task Force identified a number of principles to be considered in designing any SSO. These included:

- market responsiveness for price/quality, as a customer benchmark (i.e., comparability to direct purchase options);
- reducing regulatory burden from that imposed by the current system gas approach;
- minimizing retroactive adjustments;

- pricing stability;
- encouraging competitive market development; and
- reasonable implementation/administrative costs.

In discussions with Board staff, it became clear that reduced regulatory burden is of paramount importance to the Board. Secondary priorities are price stability, benchmarking and a desire to mitigate retroactivity.

For reasons discussed more fully below, the Task Force concluded that, pending full unbundling and the development of competitive markets, any SSO will be (as the Board itself suggested), a redefinition (and, hopefully, incremental improvement) of system gas. This is so because of the fact that the LDCs will have to continue to serve an accommodation role with respect to load balancing during the transition to full unbundling. In contrast, the Task Force expects that once full unbundling has been achieved, the primary objective for an SSO will be to provide a “safety net” for retail customers. In both instances the intent is to provide a cost-based, regulated supply option to enhance customer choice and mobility and provide a safeguard in the event markets don’t develop as anticipated.

Focusing on the primary considerations (regulatory burden, benchmarking and price stability) illustrates the trade-offs involved in any SSO design. The Task Force has attempted to highlight such trade-offs in the discussion of the primary options it considered.

**C. OPTIONS CONSIDERED**

**(i) Annual Fixed Price**

The Task Force started with a pre-disposition to a one-year, cost-based, fixed price SSO without the need for a variance account. In the particular variation postulated by the Task Force a one-year price would be approved in advance by the Board (preferably on an expedited basis) and would not be adjusted at any point during the year.

The LDCs would provide for a one year fixed price SSO by entering into supply arrangements under which suppliers would agree to a one-year fixed price and would assume all weather and displacement related risks. Additionally, long-term supply contracts would be included in the LDC's portfolio, with prices fixed through financial instruments. Unfortunately, one year fixed prices for variable volumes are not available at a reasonable price. They are essentially an option, granted by a seller, who will expect a significant premium. Preliminary analysis indicated that, given current market conditions, a significant price premium (approximately 10% of the landed cost) would be required to provide pricing stability over 12 months while also providing necessary supply flexibility to manage weather and demand variances. The Task Force viewed a premium of this magnitude to be unacceptable.

Perhaps more importantly, it was noted that the fixed price, being chosen once during the year, would have a high probability of not being market responsive. Depending on what point in the price cycle this choice is made, it could be significantly "out of the market". Moreover, such an offering would not be comparable to existing direct purchase options until retail unbundling occurs.

The underlying gas market in supply areas is daily or monthly, rather than annual. While annual fixed prices are available, for fixed volumes, they are

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“derivative” in the sense that they simply represent the market’s expectations as to future short-term price. Accordingly, they tend to change rapidly and randomly, as do market expectations for forward short-term prices.

The objectives of an annual fixed price were to provide a simple offering to retail customers which could serve as a pricing benchmark, eliminate retroactivity, provide price stability and reduce the burden of regulatory oversight. Because they are time-specific “snapshots” of future price expectations, one-year fixed prices provide end users with relatively little useful information on an ongoing basis as to what is a reasonable market or benchmark price. The better benchmarks, which reflect the true underlying market, are monthly prices. The other objectives identified for an annual fixed price SSO could be achieved, albeit at a significant premium.

## **(ii) Monthly One-Year Fixed Pricing**

The Task Force also considered a set of one year fixed price offerings which would be provided to customers on a monthly basis. In such a scenario, both system gas and the proposed SSO would co-exist for a 12-month transition period as customers chose when to “lock-in” to a one year fixed price for the commodity. At the end of the transition term, customers who had not affirmatively elected the SSO (or moved to a direct purchase option) would automatically be converted to the SSO at the final month’s pricing. There would, as a result, be twelve different fixed price offerings by each LDC.

This option, while minimizing the price premium (by “locking-in” customers and eliminating mobility variances) and assisting the LDCs ability to manage their contractual commitments, would expose customers directly to timing risk. It would also entail significant transition and administration costs and would involve a mandatory allocation of customers who fail to make an affirmative election. While

these considerations pertain to any SSO, they would be particularly visible in the case of monthly offering phased in over a one year period. It would require even more extensive customer education than will otherwise be required insofar as different SSO customers would be paying different commodity prices, depending upon the month in which they elected the one-year fixed price.

**(iii) Quarterly Fixed Price**

The Task Force also considered a quarterly pricing mechanism. The pricing mechanism (and the scope of LDC risk management) would be pre-approved by the Board and applied mechanistically each quarter to establish the forward three month price. The mechanism used to set the price would incorporate the most current pricing forecasts, weather forecasts and storage gas costs. Customers would be informed of the next quarter's price immediately prior to the commencement of the quarter.

Customers would have full mobility as they would be free to commence direct purchase arrangements at the beginning of any month.

At the end of each quarter there would be a reconciliation between the forecast and the actual costs. Those amounts would be rolled forward into the next quarter's price.

The quarterly proposal reflects an effort to balance the objectives of minimizing price volatility, reducing regulatory burden and eliminating retroactivity. With respect to the regulatory issue it is assumed that once the Board gives its approval of the pricing mechanism rates would be set in an expedited manner each quarter. The need for a hearing would be eliminated. The Board would limit the exercise of its powers to certification and audit of the process and complaint based prudence reviews. Regulatory burden could be reduced to a large

extent relative to the current mechanisms by effectively streamlining the approval process.

Although pricing would change each quarter the need for retroactive adjustments would be eliminated. In recent years retroactive adjustments have brought adverse reaction from customers and placed significant pressure and added costs on the LDCs call centre activities.

The quarterly pricing proposal does not provide a price which effectively acts as a benchmark against other offerings in the marketplace. There is also the risk that a mechanistic approach may not result in the best available price to customers. Having said that it does represent the best alternative among those considered by the Task Force and brings improvements to the current system gas pricing methodology and approval procedures.

#### **(iv) Tendered SSO**

The Task Force also considered a more aggressive SSO model which involved the LDCs designing and seeking approval for a standard one year offering (including full mobility rights) and a process for tendering blocks of system gas customers to the lowest priced qualified bidders, who would win the right to supply those customers for 12 months (and, presumably, would have an advantage in trying to convince them to switch to another option provided by the marketer).

Blocks of customers would be tendered on a geographically and temporally dispersed basis, to enable the LDCs to partially mitigate the market impact of stranded costs. At the end of the 12 month period, if the customer hadn't switched to direct purchase, the customer would be re-bid as part of another pool of customers. Effectively, all customers would be put on Agency, Billing and

Collection – Transportation<sup>3</sup> (“ABC-T”) direct sale, at prices determined through a wholesale level bidding process conducted by the LDCs.

Customers would be notified of their choices in advance of any tender and, thereafter, of their new SSO price and supplier. Similarly, they would be notified by the LDC towards the end of the 12-month SSO term (unless they had opted for direct purchase in the interim).

Although stranded costs (which arise when LDC obligations under existing contracts are interfered with) could be partially mitigated, some would still be incurred with this option if existing long-term supply contracts are terminated prior to their expiry dates. Once full retail unbundling occurs, the role played by the LDC under this option becomes quite limited (i.e., facilitating the tendering process).

Such a model might better achieve many of the policy objectives identified but would involve the arbitrary allocation of all remaining system gas customers to a specific SSO pool over a transition period. Customers allocated to different pools would pay different prices for the commodity. It would also mean that selected marketers, rather than the LDCs, would be providing the SSO. The Task Force concluded that these features of the option made it politically unacceptable at the present time but that this alternative might merit further consideration once retail unbundling occurs. It was also noted that a tendering of all existing system customers could not currently be accommodated exclusively with supply obtained from Western Canada because of limitations in the amount of TransCanada PipeLines Limited (“TCPL”) capacity held by the LDCs.

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<sup>3</sup> The LDC provides a bundled transportation service to a marketer, as agent for end use customers, whereby the LDC transports and delivers the gas that customers have purchased through the marketer (who sets the terms of gas supply with the customer). The LDC also provides ABC service to the marketer as principal, whereby the LDC bills and collects the costs of such gas supply.

#### D. CONCLUSION

After considering the foregoing and other (e.g., monthly pricing) options the Task Force concluded that, of the alternatives available, a quarterly fixed commodity price offering best satisfies the priority objectives identified by the Board. The fundamental question that remains, in the Task Force's view, is whether it is worth the cost of devising and implementing an SSO for what is anticipated to be a relatively brief transition period. The alternative would be to continue the present system gas offering pending retail unbundling.

The setting of fixed prices with variable volume carries a significant premium. Combining this mechanism with the added risk of selecting an appropriate fixed price makes it even more unattractive. In this context, the quarterly mechanism appears to be the best of a group of sub-optimal choices. Some premium is added by fixing the price for three months at a time, but other objectives are relatively well met.

It would appear that the key objective of reducing regulatory burden to the extent desirable may not be obtainable until retail unbundling occurs. The quarterly proposal might, to the extent it can be mechanistically applied, reduce regulatory burden to some extent. It is not likely that any fully bundled SSO will be an effective benchmark for comparison to other market offerings pending unbundling, since existing direct purchase, buy/sell and bundled T offerings only include commodity cost.

On balance, the Task Force recommends seeking to achieve incremental improvements to system gas by implementing a quarterly pricing model. Of the models considered, it best addresses concerns about price volatility, regulatory burden (including transition costs to implement it) and retroactivity. The primary focus, however, should be on expediting the unbundling process.

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### E. PHASING OUT THE BUY/SELL MECHANISM

The Report on Legislative Change acknowledged a number of problems with the buy/sell mechanism. It noted that “the buy/sell has been characterised by small rebate programs and the absence of a transparent relationship between the customer and gas supplier” and that “as the LDCs move from long-term contracts to more market sensitive indexed prices, the benefits of using the buy/sell have diminished.” The Report also acknowledged that “the volatility of natural gas prices has also made it increasingly difficult for the LDC to accurately reflect the buy/sell reference price. This in turn has led to more active intervention by ABMs in regulatory proceedings concerned with the setting of the buy/sell reference price. The fact that the setting by the regulator of the buy/sell reference price has become so important and contentious is evidence that the buy/sell is not a true market offering. Buy/sell is, in fact, a creature of the statutory impediments to gas transactions by gas marketers within the province.”

The Task Force believes that the buy/sell mechanism is now an anachronism and an impediment to fully competitive markets. It was designed to implement customer choice in the absence of legislative change. While, as a result, Ontario gas customers were among the first to enjoy some of the benefits of competition, the buy/sell can only imitate competition. It has oversimplified many operational and technical issues and, in an effort to protect customers, has served to confuse them and, in some respects, predispose them against competition. Permitting the unregulated sale of gas will eliminate the need for such a mechanism. The Task Force recommends that the buy/sell mechanism should be phased out on an orderly basis over a reasonable transition period.

At the same time, the Task Force recognises that the buy/sell mechanism continues to be viewed as desirable by some because of its administrative simplicity. The current weighted average cost of gas (“WACOG”) reference price used to set the

buy/sell price allows this option to include a price cap feature which offers an additional measure of protection to customers. This, of course, gives rise to market distortions that the Task Force does not believe are justified

Once the LDC merchant function is eliminated, the buy/sell mechanism will no longer be operable. In the interim, having regard for customer preferences, the LDCs have indicated their intention to honour existing contracts as long as they are able to do so (i.e., as long as there is a relevant reference price). Provisions for positive election by customers under the Addendum to the Ontario Energy Marketers Association (“OEMA”) ABC Code should facilitate the transition off buy/sell to the extent that customers will be able to convert to other mechanisms once the WACOG reference price is no longer available. While, on a transitional basis, an SSO could provide a new reference price, the Task Force would encourage the phase-out of the buy/sell mechanism as a transportation option, to be substituted for by a bundled T service.

Once retail unbundling has occurred and marketers and end-use customers are satisfied that suitable substitutes are available, they are likely to support the elimination of the buy/sell mechanism. Other forms of bundled service will continue to be offered to meet customer demand.

#### **F. RETURN TO SYSTEM OPTION**

While the Task Force was sensitive to the desirability of maintaining a “return to system” option for retail customers, it was also mindful of the fact that such an option for open-ended migration carries with it ongoing cost consequences. In addition to giving rise to regulatory burden, costs associated with maintaining this option will continue to be allocated to remaining system gas (or SSO) customers. At some point, as the number of customers over which to spread these costs declines,

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the system gas/SSO option (and the “return to system” option) will become uneconomic.

The Task Force does not believe it practical to impose an artificial deadline for forcing retail customers off system gas (or denying them the option to return to it). Rather, the Task Force agreed that there is a need to plan for and specify conditions under which system gas (or a substitute SSO) can be phased out. The Task Force recommends that all of these issues be addressed through the technical subcommittee process described below.

### **III PRINCIPLES FOR UNBUNDLING RATES POST TITLE TRANSFER**

#### **A. DESCRIPTION OF EXISTING SERVICES**

Historically, the base services provided by the LDCs are sales service, which still accounts for a significant portion of total throughput, or buy/sell service, both of which are bundled delivery services.

As noted previously, the LDCs already provide both bundled and unbundled services to large industrial customers. The LDCs’ sales and direct purchase services are “bundled” for small volume customers in the sense that they combine various gas supply contracts, pipeline arrangements, storage services and distribution facilities into a single package that moves gas from competitive production-area markets to Ontario end-users at a regulated, cost-based price.

#### **B. HISTORICAL BASIS FOR BUNDLED SERVICES**

The main reasons for the historical development of bundled direct purchase services were the then existing legislative impediments in the production, transmission and consumption markets. Because of these restrictions, customers (or their agents) purchased supply in the producing regions and utilized the existing

upstream infrastructure that had been assembled by the LDCs to move that gas to the end-users' facilities. As a result the evolution of bundled sales and transportation services, competitive price formation occurs outside Ontario in either Alberta or the adjacent U.S. States, and the delivered cost of gas to Ontario end-users is a function solely of those extra-provincial prices and the costs (passed through in cost of service rates) of intervening transportation capacity and storage held by the LDCs.

**C. EFFECT OF REMOVING IMPEDIMENTS TO TITLE TRANSFERS**

The opportunity presented by the removal of the restriction on title transfers is the potential for a broader competitive gas supply market to develop within Ontario. Such a market would consist of multiple sellers and buyers who would transact for gas volumes at a number of trading points or "market centres" inside Ontario likely at, but not limited to, the inlet points to the distribution systems. Such a market would generate "made in Ontario" market prices that would be a function of both production-area pricing and the competitive activities of non-LDC sellers functioning as holders and managers of transportation and storage capacity upstream of the LDC distribution systems.

**D. LONG RUN BENEFITS OF A FULLY UNBUNDLED MARKET**

As outlined above, "unbundling" entails (i) the separate pricing and offering of the discrete elements of LDC services (e.g., gas supply, load balancing, storage and transportation) and (ii) the further opening of these previously monopolized elements of sales service to alternative suppliers of those services. Unbundling reflects broad based efforts to (i) identify those elements of LDC service that can be provided by competitive suppliers and (ii) develop and implement regulatory and operating terms and conditions that would permit alternative sellers to function in a

competitive manner to all end users. Retail unbundling is an opportunity for competitive forces to operate in previously precluded areas of the gas market.

There was general agreement within the Task Force that the continued development of a fully unbundled market structure will create net benefits for Ontario gas users, provided the resulting market functions in a workably competitive manner.

The consumer benefits of creating a fully competitive market in Ontario, in a form generally consistent with the fully unbundled model described below, would arise from competition amongst marketers and end users to contract for and manage upstream transportation, storage and supply in the most cost-effective way possible. Although marketers and end users would face the same underlying regulated prices for TCPL transportation as the LDCs do now, the Task Force believes that allowing marketers, as well as the LDCs, to perform the function of delivering gas to Ontario city-gates, by contracting for and managing upstream transportation, storage and supply on an unbundled basis is likely to result in a range of potential advantages.

For example, individual marketers are likely to have opportunities to take advantage of economies of scale and scope if they are managing operations across a wide geographical area in Canada and the U.S.

Similarly, the existence of liquid, properly functioning current and forward markets in Ontario will provide market participants with reliable price signals in relation to the development and acquisition of new storage and transportation capacity as well as the ability to transact within the province.

The Task Force believes that unbundling downstream services (e.g., billing and after-meter services) from utility rates will be important to the continued evolution of competition and energy technology. It should create value to consumers by providing the market with incentives to create innovative products. It

will enable marketers to interface directly with retail customers and thereby, create and maintain a market presence. These and other efficiencies should encourage market entry, competition and a greater range of customer choice.

As a long run objective, the Task Force discussed what was described as a “fully unbundled” market model which would have the following features:

- A limited number of market centres would be established in Ontario at which numerous buyers and sellers of gas would trade significant volumes of gas on daily, monthly, seasonal and annual bases. These markets would generate ascertainable, competitive market prices in the daily, monthly seasonal and annual markets. With sufficient liquidity at the market centres, liquid forward markets would also develop for gas delivered in Ontario.
- Upstream transportation capacity, including capacity currently held by the utilities, would be held on an at-risk basis by end-users and marketers. Subject to operational constraints, there would be no necessary correspondence between shippers holding capacity to the market centres on the upstream transportation system and shippers on the downstream distribution systems who would take gas away from the market centres for retail sale to end-users.
- The storage capacity currently owned or controlled by the LDCs would be used by them to provide stand-alone storage services to end-users and marketers. Some storage capacity, and related intra-Ontario transportation, would be retained by the LDCs for day-to-day system balancing purposes.
- The LDCs would provide various stand-alone distribution services on their company-owned distribution facilities. These would include, but not be limited to, distribution services appropriate for retail end users. Such services would provide for the delivery on a daily basis of nominated or estimated quantities for groups of retail end users to the city-gate, for redelivery at end-use facilities in accordance with actual requirements.

Achieving this objective will involve addressing a number of complex individual and interrelated operational elements. For each element, there will be a variety of views, which are likely to change over time as the transition process

evolves. It would be presumptuous to assume that an optimal combination of conditions for unbundled service can be identified at this stage. What is essential, however, is to immediately put in place a process for doing so in a manner that will generate timely, responsive, coherent and actionable decisions to guide and accelerate the transition.

**E. POTENTIAL SERVICE OFFERINGS: FISCAL 2000**

The Task Force is of the view that a deliberate and expeditious unbundling process will underpin effective and sustainably competitive natural gas markets in Ontario. In anticipation of legislative changes which are expected to facilitate burner-tip sales of natural gas by others, the LDCs are preparing their plans to provide an expanded menu of tariff services for fiscal 2000.

The LDCs have not attempted, nor does the Task Force believe it useful to try to envisage a comprehensive menu of product and service offerings under a fully unbundled environment at this time. Rather, their focus has been on those which it is reasonable to anticipate customers will demand in the immediate future. It is reasonably certain that, under the LDC proposals, marketers will be able to “re-bundle” and provide their customers with:

- Upstream transportation (subject to recall to ensure security of supply).
- Allocation of storage and injection/withdrawal settlement (again subject to some contractual limitations).
- Allocation of transmission/distribution system DCQ<sup>4</sup> to allow for deliveries to all end use locations served.

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<sup>4</sup> Daily Contract Quantity

- Appropriate daily metering or other means of determining consumption for all end-users (including modelling/algorithm development for smaller volume end-users).
- Billing, credit and collection services.

The LDCs propose to make these services available by offering the following:

- Stand-alone distribution services, including a mechanism for forecasting daily requirements for blocks of customers. Two types of stand-alone distribution services are contemplated: those that include customer billing and those that do not (and would involve instead the LDCs billing marketers a wholesale charge for large groups of customers). Certain changes may also be proposed for large volume customer interruptible and firm services.
- Stand-alone storage services would be provided for in-franchise use to large volume end-users and marketers at cost-based rates, subject to certain operational constraints. In the long run storage ratemaking methodology will likely have to be revisited. For marketers having retail customers on the distribution systems, storage entitlements would be “tracked”, in the sense that those entitlements would be shifted amongst marketers as their relative customer sets change.
- The LDCs would assign upstream TCPL and other capacity to end-users and marketers on a “re-callable” basis, and subject to certain operational constraints. For marketers having retail customers on the distribution systems, upstream pipeline entitlements would be tracked with shifting customer bases.

**(i) Distribution Services**

Distribution costs allocated to the different rate classes will be further segregated to unbundled costs associated with billing, bad debt and load balancing (including storage). On a rate class basis, the removal of these costs will permit the development of wholesale distribution rates which will provide for the delivery of gas to end use locations. Under such wholesale rates, the marketer will be billed, by statement, for each of its customers. Should the marketer wish to contract for

billing, bad debt or load balancing services, it will do so separately for its customers' requirements.

The LDCs anticipate being able to offer several different cost-differentiated load-balancing options (e.g., annual, quarterly, monthly and daily). Marketers or end-users would contract for such service under a new load-balancing rate or (in the case of marketers) find other means of load balancing their customer base.

It is anticipated that the LDCs will also be asked to address their interruptible service for large volume customers. Again, the ability to transact sales in Ontario will make it easier for such customers to self curtail and sell their gas or transportation capacity into the market, subject to contractual constraints. This will provide customers with increased flexibility and control, enhanced by the increasing sophistication of the gas commodity market in North America. Additional interruptible rates would allow such customers to enter into a variety of arrangements with third parties or the LDC. These could include pre-specifying a level of curtailment for a contractual period and the underlying characteristics for such curtailment (i.e., notice required, maximum number of days, etc.) rather than opting to accept interruptions of service, in accordance with the interruptible contract parameters.

**(ii) Upstream Transportation Services**

The Task Force agreed that the LDCs should continue supplying contracted upstream transport at the LDC's cost (rather than marginal cost) until there is sufficient supply of and liquidity for the capacity. The concern is that for the past few years there has been a transportation shortfall and conditions in the market for TCPL transport have been such that its market value has considerably exceeded its cost (as measured by TCPL's cost based tolls).

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The Task Force agreed that upstream transport should follow the in-franchise customer until such supply/liquidity concerns are satisfactorily addressed. However, there was disagreement within the Task Force as to what the indicia would be for the existence of sufficient supply and liquidity. Some members took the position that the upstream transportation market is already at or very near a point that would justify elimination of the requirement to “track” upstream transportation entitlements to groups of end-use customers. Others took the view that sufficient liquidity meant the availability of multiple suppliers of upstream transportation other than TCPL. The Task Force agreed, however, that these issues would be most usefully considered in the context of more detailed technical discussions of the proposed technical subcommittees dealing with the design of new unbundled services. On-going developments in upstream transportation markets are likely to influence parties’ views on these matters, as will consideration of specific proposals relating to the design of future services.

Assuming a concerted effort to foster effective and sustainable competition (which entails addressing each of the other broad recommendations outlined in this Report), markets should evolve to a point where little or no value will be placed on the assignment of assets (i.e., upstream transportation capacity) as they will have been “commoditized” and readily available at a common price in the market. At that stage, the issue should be resolved naturally (or can be resolved by the Board on the application of parties seeking the release of assets).

**(iii) Storage**

Storage raises particular concerns insofar as (i) the LDCs have low cost/high quality underground storage in Ontario and (ii) the asset generally is a cost-effective load balancing option.

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The Task Force agreed that the LDCs should assign storage for in-franchise use at regulated rates on an interim basis, without prejudice to their ability to bring forward proposals with respect to such rates (e.g., possibly moving away from a cost based tariff) in the future. The Task Force did not believe it necessary to address at this time the issue of whether the LDCs own natural storage assets (and, therefore, should be entitled to whatever “rents” are available as a result of the quality of such assets).

**(iv) Summary**

In the short term, the LDCs propose to continue offering bundled delivery services, and potentially to propose new bundled load balancing and other services. There was disagreement within the Task Force as to the need for such services, and the appropriateness of retaining them, but it was thought that such issues should be dealt with in technical subcommittees.

**F. TRANSACTIONAL SYSTEMS REQUIREMENTS**

As outlined in the Working Group Report, legislative change which allows for the unregulated sale of gas in Ontario will create a need for a title transfer process to facilitate such sales.

Once the transition is complete, the LDCs may no longer have title to gas but will assume custodial responsibilities. Given the homogenous nature of natural gas and the inability to colour code it, shippers, custodians and customers must agree on the location and terms of trade for conveying title from a shipper to a customer. In addition, custodians of gas must agree on the terms and conditions under which they will serve as custodians for shippers, sub-shippers and customer gas.

Major title transfer points (which will also be price discovery points) will develop at key market locations in Ontario as desired by market participants. Initial

title transfer locations are likely to be at Dawn, Parkway (or Kirkwall), Ojibway, Niagara, Iroquois and several locations in Northern Ontario (possibly Sault St. Marie, Thunder Bay and North Bay). Additional or other title transfer locations will be determined by customer preference. These are locations where buyers and sellers will transact and where key market price attributes should be discoverable. To be of value to market participants, such price discovery points will require sufficient liquidity and transparency to yield meaningful information concerning total volume, number of transactions, average, high and low prices, number of buyers and sellers. The Task Force expects that at least one price discovery point in Ontario should also become a market centre for financial intermediation.

In a fully unbundled environment ownership of gas will allow for the direction of its movement and subsequent sale to other parties. Custody can be in the hands of the shipper, delivery company, transporter, storage company, owner, seller, buyer or marketer as designated by the owner. Custodians will ensure location, quantity, deliverability, quality and timely delivery in accordance with contractual provisions and/or industry standards. The transport storage and delivery companies (“TDSs”) will render bills for shipments to the designated shipper (owner, custodian or marketer), which will make payment in accordance with the terms and conditions of the tariff and/or contract. Movement or release of gas in the custody of the TDS will be in accordance with the nominations of the designated shipper. Balancing will be within pre-defined tariff limits, with imbalance penalties to cover shortfalls or excesses managed in accordance with pre-determined shipper arrangements. Clearance of such penalties will be completed within pre-specified periods of notification by the TDS.

Critical informational, contractual and market design issues must be addressed in the near future if title transfer is to meet stakeholder requirements, as do the pricing of certain such services (and the allocation of “development” costs).

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Intense ongoing collaboration will be necessary, particularly during the formative stages to effectively design the infrastructure of the unregulated market.

Issues to be addressed include delivery in accordance with contract or tariff, financial assurance and performance, measurement, title conveyance obligations, balancing and nominations. New transport, delivery and storage contracts will be required to effect title transfers. New financial arrangements will be required to address the distinction between custody and ownership rights and obligations. These could include ownership representations and warranties as well as financial guarantees. Remediation measures will be required to ensure that custodians can quickly and effectively resolve disputes.

A number of issues will have to be addressed relating to interconnecting pipelines, including energy balancing, nominations, management, pipeline imbalances, re-nominations, currency risk, title risk, timing differences and billing cycles and shipper requirements for ownership. Special issues may arise with respect to NRG, the City of Kitchener, the Kingston PUC, Gazifere and northern locations.

Similarly, there will be a range of new informational requirements, in respect of which standards will have to be determined and systems developed. Issues concerning ownership of customer specific and transactional information (and related privacy issues) will have to be resolved.

In each instance (whether with respect to price discovery, trading, clearing or settlement) there are a range of existing systems available. The immediate task is to choose appropriate standards for Ontario's market and begin the process of building the requisite infrastructure. This will require a number of activities in the immediate future, including:

- research into systems utilized in other jurisdictions (and for other deregulated network industries, such as electricity);
- analysis and prioritisation of stakeholder needs;
- costing;
- securing regulatory approval for system development cost recovery, if any;
- system development; and
- pre-activation system testing with relevant stakeholders.

Before embarking on efforts to develop such market infrastructure the LDCs, after industry consultation, will propose to the Board an estimate of the benefits and costs (along with a proposal to recover the costs) of the systems required to facilitate the transition to burner tip sales and title transfers. Although much of the costs might appropriately be recovered from ratepayers, funding for such systems may be allocated in other ways (e.g., licensing fees).

From a timing perspective, work must commence virtually immediately and be closely co-ordinated with customer awareness programs if currently anticipated timeframes are to be achieved. Industry consensus (and Board approval) on technical issues relating to the title transfer process should be resolved prior to the effective date of the legislation (assumed to be January 1, 1999). Several months will then be required to feed such information into the ongoing customer awareness programs. At the same time, system development work would commence, with a view to having systems in place and approved by the Board by the end of the first quarter of 2000. System testing and industry training would occur during that quarter with a view to system start-up shortly thereafter.

#### **IV CUSTOMER ACCESS TO MONOPOLY SERVICES AND OTHER ISSUES OF CUSTOMER MOBILITY**

Effective customer education and mobility are fundamental to the development of competitive markets. With respect to mobility, as with certain other issues considered by the Task Force, transitional issues raise particularly vexing problems insofar as they open opportunities for altering existing entitlements. On an ongoing basis, mobility rights carry with them costs and, as a result, could serve as a barrier to entry. For reasons discussed below, the Task Force was able to address mobility arrangements in the unbundled environment, but could not reach consensus as to governing principles for the transitional period leading thereto. Resolution of transitional concerns will require a process for Board direction, as is discussed at the conclusion of this report.

##### **A. OEMA RECOMMENDATIONS**

The starting point for the Task Force's deliberations was the recent report of the OEMA Retail Customer Education Committee on customer mobility. A copy of this report is attached as Appendix C.

The OEMA Committee focused solely on mobility at the renewal date (rather than during the term of) existing contracts.

The OEMA Committee also agreed on the necessity of further work to ensure that LDCs' infrastructure and billing systems can accommodate anticipated customer mobility transaction levels. A technical group has been assigned responsibility for working together to develop adequate capacity for the "seamless" transfer of customers between marketers.

The OEMA Committee agreed on certain protocols to ensure that customers' desires at renewal are respected. In particular, responsibilities for LDC notification and transfer of the customer account were agreed upon, although the ability of a

marketer to serve a termination notice was a matter where consensus could not be achieved. Similarly, a protocol for default supply (to system gas) during the transition process was agreed upon. While it was agreed that marketers should provide timely notification to customers of their notice and renewal dates (and so confirm to OEMA on a regular basis), there was disagreement as to whether marketers with a customer's authorization, should be able to obtain the termination dates of existing contracts from the LDC. Finally, it was agreed that marketers will provide customers with (or a second marketer, pursuant to a customer's authorization in prescribed form) a copy of a customer's contract on request.

## B. STANDARD CONTRACTS OR CLAUSES

The Task Force considered recommending a standard form of customer contract, which might be imposed as a condition of marketer licensing under the proposed legislation. Taken to a logical extreme, such a mechanism might substitute for a SSO, with a view to substantially reducing transaction costs.

The Task Force concluded that standard contracts should not be imposed by regulation. Were OEMA to achieve agreement on such a standard form of contract, it might expedite the transition out of the SSO and/or system gas. Ultimately, though, the Task Force was of the view that market forces should determine whether and how contracts are standardized. The Board should be focusing on creating a competitive market structure rather than regulating it.

The Task Force agreed that, in respect of certain matters, standard contractual clauses will be warranted. For example, the existing OEMA Code of Conduct and Customer's Bill of Rights effectively contemplate certain standard contractual provisions to be provided for in any licensing regime and/or customer contracts. Once the legislative parameters are clear and the requisite technical work has been undertaken, the Task Force anticipates that industry agreement will be achieved

with respect to standard contractual provisions regarding certain technical specifications.

### C. MOBILITY DURING TERM OF CONTRACT

Like the OEMA Retail Customer Education Committee, the Task Force was unable to achieve a consensus view with respect to mobility rights for retail customers during the transition to a fully unbundled market environment. In contrast, the Task Force agreed as to operative principles regarding retail customer mobility once such a competitive market environment is achieved.

#### (i) Transition

There was a common view of the problems arising from inadequately informed (or misinformed) customers who are locked into long-term contractual obligations with limited practical recourse, and of the potential for this concern to grow pending the transition to better informed customers and a fully competitive retail market. However, views as to the appropriate policy response diverged.

On the one hand, some of the marketer community (through their representatives on the Task Force) advanced the view that imposing any substantive constraints on the freedom of marketers to offer whatever services they choose or on their ability to enforce existing customer contracts would serve to fetter the evolution of fully competitive markets by imposing entry barriers and otherwise removing incentives for product and service innovation. They argued that customer mobility complaints can be mitigated by improving customer awareness programs and by implementing an effective licensing regime as quickly as possible. In addition, they would be prepared to consider standard disclosure requirements (or mandatory short-term product offerings) with respect to new customers (and the renewal of existing contracts). Finally, they note that the proposed legislation would

amend the *Consumer Protection Act* to clarify its application to gas marketers. Beyond these measures, this group would urge an expeditious transition to a fully unbundled retail market environment which, in their view, will be an effective remedy, on a prospective basis.

The remainder of the Task Force was less sanguine about not fully addressing the existing problem, let alone the likelihood of it growing, during the transitional period. Their view is that additional mobility rights are required for new and renewing retail customers in order to facilitate an orderly transition to a fully competitive market environment. While acknowledging that imposing any such “solutions” could cause some dislocation with respect to existing contractual obligations, they view these as necessary costs arising from the manner in which retail competition has evolved in Ontario. The LDCs, in particular, wish to be released as soon as is practicable from the ongoing need to mediate customer disputes. Given the value they place on their retail customer relationships, it is understandable that they would prefer to accept the statements of customers (or refer complaints elsewhere), rather than act as an arbiter of customer mobility (or other complaints/disputes).

Starting with this basic difference in views, a number of mobility options were explored (in addition to licensing requirements and customer awareness programs, which all agreed with).

Picking up on the discussions that took place within the OEMA Retail Customer Education Committee, the Task Force carefully considered the merits of a standard “exit fee” (as, for example, is the case with respect to the pre-payment of mortgages) to facilitate customer mobility during the term of a contract. The proposal that emerged was for a standard exit fee provision to be included in all new customer contracts as soon as possible, but not later than the effective date of the proposed legislation. With respect to existing contractual relationships, there

was a strong view that mobility rights should apply to renewals of existing contracts.

Issues such as the amount of the fee (i.e., determining a “reasonable” amount, whether it should be fixed or variable depending on the term of a contract, or whether a marketer should be able to compete on the cost of the exit privilege) would have been matters to be determined by a technical subcommittee, subject to the overriding caveat that the exit fee would have to be priced close to the marginal cost of acquiring new customers so as not to limit competition (by creating a disincentive for new entrants or for existing market participants to attempt to acquire new customers). Nor could the fee be priced so high that it would be of little practicable utility to retail customers.

Mobility rights would be subject to specified time frames, whereby an existing supplier would be given notice by the LDC and the customer would be given a prescribed number of days thereafter during which he could change his mind. Subject to contrary instructions, at the expiry of this time period, the LDC would switch suppliers in accordance with the customer’s instructions. The time frame specified in such an exit mechanism would ideally parallel mobility rights provided for in any SSO.

An advantage of such a standardized exit fee would be that, in addition to promoting customer mobility, it would allocate remediation costs more precisely (rather than having them spread out against the full rate class, which provides no incentives/penalties for inappropriate marketer conduct).

The LDCs indicated a willingness to assist the marketers in managing transport/storage risks relating to such a mobility proposal in order to better meet the needs of retail end users. They would do so by relaxing timing requirements on the usage of inventory (e.g., providing operational flexibility with respect to make-up gas). Certain marketers, however, indicated that it would be impractical for

them to manage inventory risks (i.e., value imbalances) absent the requisite tools, which will only be available to them once full unbundling is achieved. In their view, passing the costs of such mobility rights on to retail customers would serve to limit, if not eliminate the competitive market until unbundling occurs. In addition, they argued that an exit fee of any magnitude would serve to limit competition in areas other than the commodity, by discouraging the introduction of new products. Mobility rights without market liquidity is, in their view, functionally inoperable at any price.

Most Task Force members did not expect substantial mobility to result from extending a standard mobility right to customers; the power of the concept would be that it extends customer choice, even if the option is not exercised. Moreover, many felt that the introduction of a standard exit fee in new contracts would create market norms and might induce marketers to voluntarily provide mobility privileges in respect of existing contracts. Certain marketers, however, differed with these views, particularly insofar as it might effect competitive behaviour within the industry.

As an alternative to a standard “exit fee” during the transition period, the Task Force considered limiting new contracts (including renewals of existing contracts) to a one year term pending unbundling. This proposal was based on the assumption that longer-term contracts are broker (vs. retail customer) driven. Again, this was viewed as an undue constraint on competition by certain marketers, who pointed out that many of their existing customers enjoy economic benefits as a result of having entered into longer term contracts.

A final alternative considered by the Task Force with respect to transitional period mobility rights would be for the LDCs to withdraw from their role in mediating customer mobility disputes by simply taking direction from customers (or their appointed agents). Leaving aside concerns about conflicts of interests

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(which are or can be addressed through affiliate codes of conduct), this option gives rise to concerns with respect to the legal obligations of LDCs under agency law. This is a matter that the LDCs have taken under advisement.

**(ii) Unbundled Environment**

The Task Force agreed that the unbundled market will provide more flexible customer offerings, will enable marketers to fully manage mobility risks and will allow the LDCs to withdraw from their intermediate role between retail customers and marketers. In such an environment there was consensus that (i) LDCs should be able to take direction from retail end use customers and (ii) that the right to use “downstream” assets should follow such customers. It was agreed that a technical subcommittee should be charged with addressing how to achieve these objectives in contractual relationships without giving rise to undue transaction costs.

**(iii) Conclusion**

While agreement was achieved with respect to the principles guiding mobility rights post unbundling, the Task Force was unable to achieve consensus with respect to appropriate mobility measures during the transition period to a fully competitive retail market. There was a fundamental divergence of views as to whether industry standards (or regulatory intervention) are appropriate in the short term. All agreed that the issue is one of significant concern and that it cannot be isolated from the other issues addressed in this report.

As is discussed below, the Task Force recommends that this issue be subject to some form of process which, in default of a proactive industry consensus, leads to Board direction as to the issues of principle. Ideally, the prospect of such direction will assist the industry in achieving agreement as to appropriate interim initiatives – demonstrating the collective desire on the part of market participants to raise

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customer awareness and service standards as part of the transition to a mature, competitive retail marketplace.

#### D. COMPLAINTS/DISPUTE RESOLUTION

The Board raised an issue as to whether suppliers or end users should control access to monopoly assets. This concern lies behind the issue of whether the LDCs should act as “police” in enforcing contracts between marketers and end users by refusing to recognize new suppliers even where instructed by its customer to do so. As noted above, the Task force was only able to achieve consensus on this issue in respect of a fully unhandled retail market.

In the interim, all are supportive of dedicating additional resources to ensure that OEMA can continue to effectively assume more of the complaints/dispute resolution role, thereby relieving pressure on the LDCs (and on various government agencies) to do so. Given an adequate time period to attempt to resolve complaints directly with the customer, the marketer representatives on the Task Force indicated a willingness to bear the direct costs of mediation, efforts which, to the extent they are borne today by the LDCs, tend to be reflected in the full rate class. The Task Force sees merit in eliminating this cross-subsidy.

Once retail services are fully unbundled, other mechanisms to reduce the costs of mediation should be considered. In addition to universal mobility rights, marketers might be given the right (subject to a reasonable notice requirement) to terminate supply.

More generally, in an unbundled environment the onus should be on the supplier of goods or services to obtain and enforce judgements (and to protect themselves in respect of such risks as they see fit), without the ability to seek the intervention of the LDC to shut off gas supply to the (former) customer.

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## E. THIRD PARTY VERIFICATION

Another initiative currently under consideration, which the Task Force endorses and views as an essential complement to the customer awareness initiatives discussed below, is the use of third party verification for residential and small volume commercial customers to minimize subsequent disputes as to the existence of a contract. The LDCs, pending unbundling, intend to ensure that any such process also satisfies their obligations to end-use customers (insofar as the LDCs receive complaints that either the market didn't fully inform customers as to the choices available to them or that end users were switched to another supplier without their knowledge or consent).

There are a number of mechanical and cost allocation issues to be resolved in respect of such a proposal. Who should be qualified to act as a third party verifier? On whose behalf can they act? How should costs be allocated? In addition, there are system design concerns, the most important of which is to minimize the delay between customer sign up and verification, so as to extract full value from the verification process. These issues should be addressed to allow for implementation as quickly as possible. At least one LDC is in the process of implementing such a system, for which there is ample precedent in other industries and jurisdictions. Through experience, this implementation should provide valuable information related to the mobility and other customer complaints considered above.

## V CUSTOMER AWARENESS PROGRAMS

There is universal support for broad, deep and consistent customer awareness programs. A significant educational effort will be required to change the expectations and attitudes of market participants concerning gas service. As regards retail customers, one of the Board's responsibilities should be to assure the dissemination of sufficient understandable information concerning the changes that will take place in the gas industry and how customers will be affected by these

changes so that they are equipped to make informed service choices. Such customers should also be informed of their rights, so that they can seek recourse if they are dissatisfied with their service or are subjected to fraudulent actions.

In its Report on Legislative Change the Board indicated its belief that “access to market information is the key to informed choices and is a necessary precondition to the removal of a regulated supply offering” and that “the expertise of the Board, the LDCs and other natural gas industry stakeholders should be combined ... to develop an effective educational program.” While acknowledging that many retail customers have already selected direct purchase options, the Board indicated concern as to “the extent to which these customers understand the price they will pay or the terms of their arrangements.” The Task Force concurs whole-heartedly. Even prior to retail unbundling, there is a pressing need to better inform customers about their competitive options.

The unbundled, competitive market places significant responsibilities on each customer. Preserving traditional consumer protections may not be consistent with full-scale unbundling (to the extent they impose entry barriers). Hence, the effective introduction of unbundled service requires considerable user education, particularly for the residential and smaller volume commercial users. Such customers can best benefit from unbundling if they are knowledgeable about the available market options and the consequences of their choices.

In the Task Force's view, each of the relevant Ministries, the Board, the LDCs and the marketers should be embarking upon complementary and multi-faceted campaigns to increase customer awareness of deregulation, legislative change and their purchasing options and obligations. Ultimately, the Board must establish a policy framework within which stakeholders can disseminate necessary, sufficient and understandable information so that users can make their service choices in an informed manner. This should involve a direct communications program (e.g.,

advertising, call centre, maintenance of a web-site) as well as oversight of complementary campaigns undertaken by the LDC and marketer communities.

#### A. IMMEDIATE CAMPAIGN

At this stage, the primary constraining factor is the lack of certainty as to certain key public policy parameters. Facing this constraint, the LDCs have devised and are in the process of implementing a short-term (one year) customer education program. The initial phase of the program should occur as soon as is practicable, in anticipation of heightened marketing efforts during the summer months. The plan has been designed so that its messages and media can be modified over time, both in response to consumer feedback and to legislative/market developments.

The initial messages should be twofold. Firstly, it will seek to instill in consumers a sense of responsibility, educating them as to the choices available and their need to ask questions and become better informed consumers. Secondly, it will try to convey the efforts of the industry to help customers enjoy the benefits of a changing market place.

While the Task Force favours communicating to the public an image of a responsible, pro-active and co-operative industry, committed to facilitating an orderly transition to competitive markets, there was some concern that the thrust of any customer awareness program, to the extent it is to be funded by customers through regulated rates, should be educational rather than promotional. Addressing this concern (i.e., to ensure that the messages to be communicated are consumer relevant and satisfy certain public interest sensitivities) requires stakeholder input into the principles underlying such a campaign and LDC adherence to such principles in the execution of the campaign. Mechanisms for securing such input on an ongoing basis are reflected in certain proposals discussed below. A willingness to work together on an expedited basis to agree upon more

detailed principles for the immediate campaign was indicated by all Task Force members.

## **B. ON-GOING CUSTOMER AWARENESS PROGRAMS**

Once key public policy issues have been determined, a broader customer awareness campaign should be developed. As noted above, the Task Force would urge the Province/Board to implement a campaign to directly communicate public policy. It will be incumbent on the policy-makers to publicise the availability (and anticipated benefits) of further deregulation and unbundled services and the potential consequences of such services for consumers. In addition to LDC efforts, the Task Force would encourage the marketer community to demonstrate leadership in this area as well.

The Task Force does not view itself as expert in the details of consumer awareness campaigns. Rather, as with other technical issues, it envisages the need for a mechanism (discussed below) to ensure the alignment of messages and sensitivity to consumer advocate/public interest concerns. Such a mechanism should facilitate broad input and quick-decision making. It should also ensure the participation of certain constituents (e.g. consumer representatives) who will require funding. Subject to appropriate oversight, the Board should be prepared to rely on the integrity of such an advisory process.

Such a mechanism should also be designed to facilitate the integration and alignment of customer awareness programs focussed on electricity as well as natural gas, to the extent practicable.

## **VI NEXT STEPS**

In the limited time available to it, the Task Force was able to agree on certain broad recommendations and identify a host of complex, often interrelated technical

issues that will have to be addressed during the transition (not the least of which are those relating to the design and implementation of the requisite market infrastructure). It is certain that other technical issues will emerge once public policy determinations are made and as the transition process unfolds.

Effectively resolving such issues will be an intense and continuous process over the next year or two, which will require prompt and effective decision-making capability on the part of all stakeholders. The Task Force is of the view that the Board's traditional consultative and decision-making processes do not easily lend themselves to the task. While OEMA should play an important role as a forum within which market participants address issues of mutual concern, a broader stakeholder base and a more targeted mechanism will be required to advise the Board.

Most jurisdictions that have determined to proceed with unbundling have also devised collaborative processes to facilitate the resolution of technical issues with least costs and the least amount of regulatory intervention. Most tend to utilize highly focused and collaborative advisory groups which encourage direct communication between technical personnel. Properly "facilitated", this tends to reduce the persistence with which parties pursue their optimal objectives and minimize the need for costly "due process" related resources (not the least of which is the passage of time).

In this context, the Task Force suggests that the Board take advantage of three instruments to support its policy-making role during the critical transition process.

**A. NEW REGULATORY INSTRUMENTS/PROCESSES**

While, in preparing this report, the Task Force was constrained by time and resources, such constraints did not prove insuperable to achieving agreement as to actionable principles except with respect to the issue of customer mobility during

the transition to a fully unbundled environment. The Task Force's inability to achieve consensus on that issue would not, in the Task Force's view, have been overcome by additional time or resources. Rather, the Task Force concluded that this impasse points to the need for a mechanism whereby the Board can provide direction on an expedited basis (or otherwise enable the Task Force to resolve issues) where consensus cannot otherwise be achieved. While the Task Force did not have the time to devise such a mechanism, it was evident that Board input will be required, either to empower the Task Force so that decisions can be internally generated from it, or so that there is a "fall back" Board decision-making process to resolve issues of principle in the absence of consensus.

Once issues of principles have been agreed upon by the Task Force (as was the case with respect to all issues except transitional customer mobility) or otherwise determined, the Board should be approving terms of reference, developed by the Task Force, so that they can then be referred upon the technical subcommittees discussed below.

Many of the issues canvassed by the Task Force are, in its view, ready to be referred to technical subcommittees. The Task Force would be prepared to work with the Board to develop detailed terms of reference so that such subcommittees can proceed with the benefit of clear guiding principles and a detailed work plan. However, given the inter-relatedness of all of the issues considered by the Task Force, it is reluctant to refer any work to technical subcommittees until there is a process in place for settling principles (and the resultant terms of reference) at least with respect of each of the issues addressed in this report. In other words, both the Board and the Task Force should have a settled view of the overall "end-state", which can serve to inform all of the detailed work, before any such work is undertaken. Such a view may change over time, but would be the basis upon which technical work (and the Task Force's oversight thereof) could proceed in a coherent manner.

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Given the urgency of the work at hand and of the Task Force's success in achieving consensus (or, at least, actionable compromise) on all but one of the significant issues posed to it, the Task Force would welcome the opportunity to work with the Board to devise an appropriate decision-making process for resolving issues where consensus cannot otherwise be achieved. The Task Force recognizes that any such mechanism would require a commitment from all stakeholders to abide by the resulting decisions and continue their constructive participation in the consequent market design processes.

In addition to this immediate concern, it is evident that, during the transition process, regulatory streamlining will be necessary to reduce the time constraints and costly administrative burdens of traditional regulatory mechanisms. New mechanisms will be required to inform and facilitate consensus building and expedite policy decision-making and approval/implementation processes.

One such mechanism could be the use of the Board's proposed rule-making authority to propose, review and finalize rules and standards in respect of the transition and market design processes. The use of such rule-making authority might significantly reduce time lags and the "process" burden on all involved, without compromising the ability of all interested parties to provide input to and be kept informed of the relevant decision-making process.

## **B. TRANSITION TASK FORCE**

Subject to the foregoing (and the Board's concurrence with the direction of the Task Force's recommendations), the Task Force suggests that it continue to provide the Board with actionable recommendations during the transition process. Obviously, the Task Force would defer to whatever changes the Board determines appropriate with respect to its composition, staffing and the like. The key would be that it remain small and sufficiently collegial (a quality that, hopefully, will continue

to increase over time) to be able to formulate and render consensual advice quickly. It must also be sufficiently knowledgeable and representative of the various constituent perspectives to ensure that the advice is informed, **balanced** and reflects (or, at least, takes into account) the views of various stakeholders.

### C. TECHNICAL SUBCOMMITTEES

In contrast to the manner in which it has operated during the past month and a half, the Task Force should, in consultation with the Board, constitute a number of issue specific "technical subcommittees" composed of individuals with the competence to address particular issues of concern. As noted above, such technical subcommittees will require detailed terms of reference and broad principles to focus their deliberations. The technical subcommittees would submit their recommendations to the Task Force, which would be responsible for reviewing, checking for consistency and oversight.

In addition to assigning and co-ordinating the work of such technical groups, the Task Force would be charged with assimilating their advice and, in turn, providing overall guidance to the Board. Any such guidance (as well as all reports furnished to the Task Force by the technical subcommittees) should be transparent (i.e., available to all interested parties). On receipt of advice from the Task Force, the Board would have to determine, on a case by case basis, whether and, if so, what additional consultative procedures were merited.

The technical subcommittees would help the industry move forward constructively and on a timely basis on technical issues that require integration of systems and procedures to ensure that the transitional phase of deregulation works smoothly with a minimal of contractual risk and uncertainty. This process should also assist in developing industry standards to help minimize resource investment and duplication of processes or procedures.

Initially the technical subcommittees would be requested to develop recommendations and procedures related to the technical (as opposed to rate design, rate of return or cost of service) issues associated with implementing title transfers in Ontario. Given the magnitude of these issues there will be a need to establish several subcommittees to deal with both technical and contractual redesign issues.

Based on the proposed timing of the legislative changes, the Task Force recommends that these technical subcommittees be established in early summer to allow for parallel development of the title transfer model. Assuming final approval of the legislation has been received in the fall the title transfer technical subcommittees would be asked to provide their recommendations prior to November 30, 1998.

In addition, technical subcommittees could deal with technical details concerning customer mobility as well as help with the co-ordination of customer awareness programs.

## VII CONCLUSION

For most of this century, industries such as energy, transportation and communications tended to exhibit some type of scale economies, such that a single firm would have the lowest cost of production and could monopolise. Hence, such industries were treated as natural monopolies and economically regulated (or publicly owned) to control entry, prices and profits.

In recent decades, technological improvements and economic growth have reduced the importance of scale economies, increased access to capital and changed perceptions about the potential for economic efficiency. These changes have led to new products, delivery systems and unregulated service providers. As a consequence, many industries have restructured to rely more on competition. In general, such restructurings have improved economic efficiency because they grow

directly out of opportunities to lower costs. In addition, by substituting market discipline for regulation, when competition is viable, incentives for efficient behaviour bring additional pressures to lower prices. As a result, such restructurings have generally achieved overall benefits, both for consumers and the economy as whole.

It is in this context that the restructuring of Ontario's natural gas industry has reached a critical juncture. It is important to recall that the process is not, at its heart, a regulatory phenomena. Rather, it is driven by economic and technological forces that, in driving the industry to adapt is also, by necessity, causing regulation to change. The future of the gas (and electric) industry will not be the only things to be determined.

It is clearly no longer in the public interest for the natural gas industry to continue to mould and shape itself to fit an outdated regulatory framework. Realigning the industry, adjusting regulations and facilitating the "cultural change" for firms, regulators and consumers alike has become a pressing task. The costs of delay, in the face of parallel processes in other jurisdictions and energy sectors will prove increasingly costly.

## VIII SUMMARY OF RECOMMENDATIONS

### A. INTRODUCTION

The Task Force believes that the Board should encourage an aggressive program to remove elements of the existing regulatory structure that are impeding the evolution of open and competitive markets. While existing commitments should be honoured (or managed until they can be wound down), the best way to deal with the transition is to promote effective competition and informed customers. Rather than attempting to design market mechanisms, or delay the transition process

unduly, the Board should continue to promote legislative reform and industry leadership designed to allow appropriate market infrastructure to evolve on its own. (I. B)

**B. PRINCIPLES AND CHARACTERISTICS OF THE STANDARD SERVICE OFFERING**

The Task Force concluded that, of the alternatives available, a quarterly fixed price offering best satisfies the priority objectives identified by the Board for redefining system gas during the transition to full retail unbundling. (II.D)

The Task Force encourages the phase-out of the buy/sell mechanism as a transportation option, to be substituted for by a bundled T service. (II. E)

The Task Force agreed that there is a need to plan for and specify conditions under which system gas (or a substitute SSO) can be phased out. (II. F)

**C. PRINCIPLES FOR UNBUNDLING RATES POST-TITLE TRANSFER**

The Task Force believes that the development of a fully unbundled market structure will create net benefits for Ontario gas users, provided the resulting market functions in a workably competitive manner. (I. B and III. D)

The Task Force agreed that the LDCs should continue supplying upstream transport at the LDC's cost (rather than marginal cost) until there is sufficient supply of and liquidity for the capacity. (III. E. ii)

The Task Force agreed that the LDCs should assign storage for in-franchise use at regulated rates on an interim basis, without prejudice to their ability to bring forward proposals with respect to such rates in the future. (III. E. iii)

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The immediate challenge is to begin designing and building the requisite market infrastructure (including transitional mechanisms) to facilitate effective and sustainable competition. This work must commence immediately if unbundling is to be successfully introduced in fiscal 2000. It must be closely co-ordinated with customer awareness programs if such timeframes are to be achieved. (III. F)

**D. CUSTOMER ACCESS TO MONOPOLY SERVICES AND OTHER ISSUES OF CUSTOMER MOBILITY**

While industry may achieve agreement on standard clauses (or standard contract forms) the Task Force would encourage the Board to focus on creating a competitive market structure, rather than regulating it (by mandating whether or how contracts are standardized). (IV. B)

Once the legislative parameters are clear and the requisite technical work has been undertaken, the Task Force would encourage industry efforts to agree on standard contractual provisions in respect of technical specifications. (IV. B)

The Task Force was unable to reach a consensus with respect to customer mobility rights during the transition period to full retail unhandling. Thereafter, it agreed that (i) LDC's should be able to take direction from retail end use customers and (ii) that the right to "downstream" assets should follow such customers. (IV.C)

The Task Force agreed that mechanisms should be devised to extricate the LDCs from playing a mediation role with respect to customer complaints/disputes concerning marketers. In the immediate future, dedicating additional resources to ensure that OEMA can effectively assume this role is warranted. With unbundling, other mechanisms to reduce the costs of mediation might be explored. In particular, in unbundled environment the onus should be on the supplier of goods or services to obtain and enforce judgments, without the ability to seek the intervention of the LDC to shut off gas supply to the customer. (IV. D)

The Task Force encourages the use of third-party verification to minimize ex post facto disputes as to the existence of a contract. (IV. E)

#### **E. CUSTOMER AWARENESS PROGRAMS**

The Task Force believes that each of the Province/Board, the LDCs and the marketers should be embarking upon complementary and multi-faceted campaigns to increase customer awareness of de-regulation, legislative change and their purchasing options and obligations. (V.B)

The Task Force favours an immediate campaign, devised by the LDCs, subject to ongoing prior review of the “messages” to be communicated to ensure that they are relevant to customers and satisfy certain public interest sensitivities and to faithful adherence to such principles in the campaign’s execution. (V.A)

Once key public policy issues have been determined, broader customer awareness campaigns should be developed. (V. B)

#### **F. NEXT STEPS**

The Task Force focused on certain broad recommendations, while identifying numerous complex, inter-related technical issues that will have to be addressed during the transition. Subject to the development of a default mechanism for resolving issues of principle in the absence of consensus, it recommends that a transition Task Force, constituted similarly to itself, continue during the transition process. (VI. B)

The Task Force encourages the Board to use more flexible regulatory mechanisms to expedite the proposal, review and approval of rules and standards in respect of the transition and market design processes. (VI. A)

The Task Force should co-ordinate and oversee the work of task-specific technical subcommittees relating to the transitional phase of deregulation. (VI. C)

The deliberations of the technical subcommittees and the Task Force should be transparent. Once the Task Force has formulated advice to the Board, the Board would have to determine, on a case by case basis, whether and, if so, what additional consultative procedures were merited. (VI.C)

## APPENDIX A

May 7 Notice to E.B.O. 202 Participants

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**APPENDIX B**  
**ASSUMED TIMETABLE**

June 1998	MDTF Report Legislative change introduced
Summer 1998	MDTF Technical Subcommittees initiated
November 1998	Technical Subcommittees report (through MDTF) to Board
Early 1999	SSO implementation Legislative change effective
Spring/Summer 1999	LDC rate case submissions
Early 2000	System testing retail unbundling

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## APPENDIX C

### OEMA Retail Education Committee Report on Customer Mobility

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