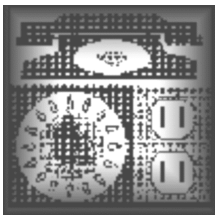

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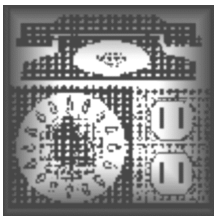
Economic & Financial Resources

Natural Gas Regulatory System Study



EFR LTD.

Natural Gas Regulatory System Study
prepared for
The Urban Affairs Committee
of
The Nebraska Unicameral

EFR Ltd.
Ankeny, IA

January 3, 2001

CHAPTER 1

Summary

This report reviews the nature of the natural gas industry in Nebraska. Natural gas is a major source of fuel in Nebraska. More Nebraskans are depending on natural gas to heat their homes this winter than any other fuel. In this winter of record high gas prices, and one of the coldest winters on record, the natural gas market is very important to Nebraskans. Nebraska households are facing heating bills that are more than double last winter's bills.

Four investor-owned and sixteen publicly-owned natural gas companies serve Nebraska. Neligh is a potential seventeenth if it successfully litigates its status as a municipal gas utility. Two of these investor-owned gas utilities combined serve customers across the state, KN Energy and People Natural Gas Company, a division of UtiliCorp. KN Energy serves nearly 100,000 customers while Peoples Natural Gas Co. serves nearly 180,000 customers. Two others, NorthWestern Public Service Co and MidAmerican Energy, serve only in four and two municipalities, respectively. The municipally owned utilities range from the largest, Metropolitan Utilities District (MUD) that serves some 176,000 gas customers in the Omaha area, to small towns with utility departments that serve only a few hundred customers.

Though natural gas deregulation has made headlines, the deregulation, where it has occurred, is limited. Only the sale of the natural gas, the fuel itself, has been opened up to marketers other than the gas utility. The sale of the gas by the suppliers frequently remains subject to controls enforced by the regulatory body. These controls enforce fair competition

between the marketers, fair relations between the local gas distribution company (LDC) and the gas marketers, and consumer protection for customers. The gas delivery system owned by the local gas distribution company continues to be subject to traditional rate, service and safety regulation.

The Federal Energy Regulatory Commission continues to regulate the rates pipelines charge to move gas from one state into another. Even states with the most extensive consumer choice programs continue to regulate the delivery system operated by the local gas distribution company. This regulation continues because the LDC continues to have a natural monopoly, it being too costly to have a number of pipes owned by several companies buried under the streets of cities and towns. The control of the gas supply market continues to ensure that customers have access to the supplies of gas available in a market place where competitive standards are enforced.

Regulatory bodies have a more complex natural gas industry to deal with today compared to prior years. Where formerly their only concern was a single gas utility within an area, now the area still has one gas delivery system with some customers continuing to buy exclusively from the utility, but others buy from a variety of gas marketers. Fair dealing between the gas delivery company and the marketers has to be policed. Some consumer protection has to be provided customers dealing with the gas marketers. For a working market to function effectively, rules have to be in place that promote competition and restrict abuse of market power by dominant gas marketers, and deter unscrupulous practices by suppliers.

The four investor-owned utilities (IOU) take delivery of gas they purchase principally from two pipelines, KN Interstate Pipeline in the western two-thirds of the state, and Northern Natural Gas Pipeline in the eastern one-third. Other pipelines delivering to Nebraska utilities include Natural Gas Pipeline Co., Trailblazer, ANR and Williams Gas Pipeline. The Federal Energy Regulatory Commission determines the rates these pipelines charge. In the case of Peoples Natural Gas Co., Peoples first buys the gas for residential and commercial usage and retails it to these customers. In the case of KN Energy, its Consumer Choice program permits customers to buy from a number of gas suppliers including KN Energy or its affiliate, KN Gas Services. Municipal gas utilities do not have consumer choice programs operating at this time. They buy gas and resell it to their residential and commercial, and some industrial customers.

Many industrial customers do purchase their gas supply from marketers. Their gas is then usually transported through the LDC's delivery system paying the transportation or delivery charge only. Some commercial customers also have an opportunity to purchase their own gas.

Nebraska prices for natural gas vary considerably from one part of the state to another. MUD in Omaha has the lowest typical bills for residential and commercial customers in the state, while Ponca, a small town in northeast Nebraska served by a municipal utility, has the highest. KN Energy and Peoples Natural Gas Co.'s typical bills for out state Nebraska towns and cities are higher than average bills for residential and commercial customers in urban areas in Nebraska or bills in adjoining states charged by the four investor-owned gas utilities.

Some municipal gas utilities in Nebraska have typical bills higher than these bills from investor-owned utilities in adjoining states.

The study of typical gas bills shows Nebraska's out state utility rates to be high. There are several reasons for the higher rates—different gas costs, pipeline transport charges, gas delivery system differences, different taxes and margins, and strengths and weaknesses of regulation in Nebraska and the adjoining states, which all have state regulatory commissions.

Nebraska has the last remaining regulatory system where municipal governments solely regulate natural gas rates. This regulatory framework was set up in the Municipal Natural Gas Regulatory Act passed in 1987. This Act, codifying much of the existing regulatory apparatus, permitted cities to band together to hold a joint area rate proceeding when a gas utility files a rate change. This Act only permits a minimal form of regulatory oversight of natural gas rates in Nebraska. Only residential and commercial customers within municipal boundaries receive any regulatory protection. Industrial, rural and agricultural customers have no rate protection. However, even the regulatory protection the municipalities can exercise within the city limits is very limited. The cost of gas has not been examined closely, if at all, in area rate or gas cost recovery reviews. This is in part because the gas utilities have opposed such oversight, and the municipalities have not pursued oversight of the gas costs.

A number of shortcomings leave the municipalities unable to carry out regulatory responsibilities. These shortcomings include:

- A weak regulatory act,
- A lack of expertise arising from infrequent rate cases and turnover of municipal officials and employees,
- Time limitations of the volunteer regulators when reviewing a case,
- Frustration, and growing indifference, of municipal officials after thirteen years of the Act, and
- A weak organization of a loosely gathered group of cities, each with its own, often different, agenda, pitted against a coordinated centrally controlled corporation.

The area rate proceeding format is no longer operating effectively. The larger cities simply circumvent the area rate proceedings, choosing rather to negotiate a conclusion with the city, often with little reduction in rates from what the utility proposes. Certain cities have gotten economic development contributions or other financial advantages as an incentive for the city to settle, a practice representative of neither good regulation or good government. The smaller towns and villages simply have become frustrated because of their inability to use the area rate proceedings effectively, and in many cases have become unwilling to even participate actively in the rate proceedings.

Also, the Municipal Regulation Loan Fund from which municipalities could borrow funds and pay expenses associated with the area rate proceedings has ceased to work. As the rate case expenses are paid, the utility is to then repay the loan, and in turn, the utility recovers the repayment from customers' rates. This Loan Fund had worked reasonably satisfactorily until

recently. After a municipally initiated rate reduction action against KN Energy, KN Energy's strident opposition included a refusal to repay the Loan Fund. Currently this lack of funds to pay any regulatory expenses of municipalities halts any possibility of serious regulatory efforts by the municipalities in Nebraska.

This report further updates the Committee and the Unicameral on the status of ongoing Federal activities affecting the natural gas industry. Also, the report reviews the operation of Consumer Choice programs in Nebraska. About twenty percent of KN Energy customers, consistent with national trends, selected another supplier of natural gas than the gas utility itself. However, the customer savings appear to have been small, again consistent with national results. An earlier consumer choice pilot program carried out in Peoples Natural Gas Co.'s service area for commercial customers is no longer functioning.

This report presents the Urban Affairs Committee, the Unicameral, and the State of Nebraska with two alternative proposals—one, to strengthen the existing municipal regulatory system with centralized resources and staffing, to strengthen the regulatory authority of the municipalities, and provide enforcement powers. The report cautions that even strengthening municipal regulation still leaves the municipalities with limited regulatory authority.

Alternatively, the report recommends a state regulatory board be established. This Gas Agency should have not only traditional regulatory powers over revenues and rates, service, and terms and conditions of service, it should be authorized to deal with the changing gas supply. The Agency needs authority to ensure fair dealings between the gas delivery utility and the gas marketers, to protect consumers from unfair business and sales practices of gas

marketers, and to educate consumers on how to purchase their gas supply. This would require a more flexible authority to hold hearings, to set policy, mediate, and settle disputes than is commonly associated with regulatory commissions. This Agency should be set up to move faster and respond more easily to the changing natural gas markets than the traditional utility commission.

This report does not endorse this assignment of natural gas regulatory authority to any given part of Nebraska state government. Equal consideration should be given to setting up a new agency to regulate Nebraska gas utilities versus assigning the task to an existing agency. Both options should be fully examined. It is noted, however, that a number of municipal regulators, when surveyed, did not feel the Nebraska Public Service Commission could effectively replace municipal regulation of natural gas rates. The Nebraska Public Service Commission does not have standing experience or expertise regulating energy. Its history has been in the regulation of transportation and telephones. The practice in energy regulation differs markedly from the regulatory practices exercised over common carriers and telephone companies. Additional staff and resources will be necessary for whatever agency is assigned the regulatory assignment.

Major reconstruction is required of the gas utility regulatory system in Nebraska. It principally recommends that a state-wide regulatory agency be authorized to regulate gas utilities, particularly investor-owned utilities. This report does note certain small municipally-owned utilities have high prices, and may be too small to be fully self-operating when facing the pressures imposed when dealing with a national gas market place. This report emphasizes

that any natural gas regulatory board should do more than exercise the traditional regulatory authority over rates and service of the monopoly gas utility. The natural gas regulatory agency must anticipate and guide the competitive gas supply markets as they progressively become partially competitive. Authority, resources and staffing will be necessary to make this flexibility possible. The report offers a second alternative proposal that municipal regulation be reinforced and strengthened. However, the report points out such a proposal would continue a relatively weak regulatory structure.

CHAPTER 2

Overview of the Study

EFR Ltd. submits this report on the natural gas industry and municipal regulation of investor-owned utilities to the Urban Affairs Committee of the Nebraska Unicameral. EFR Ltd provides expertise regulatory expertise in regulatory policy and procedures, economics, utility accounting, federal natural gas restructuring and unbundling. Our experts, listed below, have seventy-eight years experience in utility and natural gas regulation.

EFR Ltd.'s philosophy is government bodies need high quality expertise when considering changes to utility regulation. EFR Ltd. has applied its natural gas regulatory expertise in preparing the study for the Unicameral's Urban Affairs Committee.

Principals

- Michael L. Arndt
  - CPA
  - Active in public utility regulation since 1974
- Eugene F. Rasmussen
  - Economist
  - Ph. D.
  - Worked with utility regulation since 1976
- Wm. H. Smith
  - Lawyer and economist
  - Involved with state and Federal utility commission regulation for 28 years

EFR Ltd. believes the Committee's concern with the effectiveness of municipal regulation in Nebraska is well placed.

The regulation of the natural gas industry can encompass several different activities of the local gas distribution business. These areas include: rates, of course; service quality; requirements to provide service to customers who apply; safety; security issuance and financing; unfair competition by affiliates and assignment of business territories. In the last twenty-five years, the role for regulators has expanded to include more than just regulatory control over the rates charged by the utility and the minimum level of service quality. Now utility regulation is concerned with consumer protection, development of competitive markets and the workability of multiple vendors of natural gas using the facilities of a sole local distribution company to deliver gas to customers.

Nebraska is the last remaining state where the municipality, though its grant of franchises, has plenary power over natural gas rates. The 1987 Nebraska Municipal Natural Gas Regulation Act consolidated the investigative and hearing portions of the municipal rate determination process across an area wide, instead of city-by-city, proceeding. No longer was it necessary for every municipality to duplicate rate review procedures. Groups of municipalities within areas outlined by the gas companies could band together to jointly investigate the rate filings and hold hearings. Further, the Municipal Natural Gas Regulation Revolving Loan Fund was established, to be administered by the Nebraska Energy Office, permitting the funding of the municipal rate proceeding.

The Loan Fund presently has no funds available to finance any municipal regulatory activity should a case be filed in any rate areas. The Loan Fund needs prompt action to lift this regulatory hiatus.

Furthermore, rate regulation is sharply circumscribed in Nebraska. Rate regulation is limited to the rates on sales to residential and commercial customers served within municipal city limits. The rates paid by large commercial and industrial customers, and customers outside municipal boundaries, such as agricultural customers, receive no regulatory review in Nebraska. Also, the cost of the gas supply has not received serious scrutiny.

The Nebraska Municipal Natural Gas Regulation Act limits oversight of residential and commercial rates**.** In Nebraska, some of these other regulatory functions are assigned to state agencies, some to municipalities, some to the courts and several left unregulated. Lying atop the municipal regulatory power is the power of the Nebraska courts to review municipal rate decisions.

The Committee's interest in consumer choice of natural gas suppliers to retail customers is well placed. In Nebraska's pilot unbundling program, almost all residential and commercial customers in KN Energy's Nebraska service areas are participating in the state's only customer choice program. KN Energy, which serves about one-fifth of the state's residential and commercial customers, initiated its Nebraska Choice Gas Program in April 1998 as a step to unbundling natural gas services in the state. Under KN Energy's program, residential and small commercial customers in 180 communities served by KN are eligible to choose

among five suppliers for their natural gas. Two of these however, are KN Energy itself or its affiliate, KN Gas Services.

EFR Ltd. approached this study systematically. Our approach to this study is outlined below.

Steps in Project

- Initial Tasks Completed
  - Detailed Work Plan Laid Out
  - Initial Meeting Held With Utilities, Suppliers and Municipalities
  - Questionnaires Sent Out to Municipalities, Suppliers and Municipalities
- Analysis Steps Carried Out
  - Gathered Responses to Questionnaires from Utilities and Municipalities
  - Compared Typical Bills and Rates
  - Reviewed Rate Setting Procedures
- Goals Achieved
  - Identified the Nebraska Gas Industry
  - Determined Municipal Regulatory Needs
  - Examined Consumer Choice Options

Two major studies were carried out. The first involved identifying typical residential and commercial customers and calculating the bills they would pay normally for each utility, whether investor-owned or municipally-owned, in Nebraska. The residential user was determined for an average homeowner heating with natural gas during a normal heating season. Two types of commercial users were defined. First, types of business that

could operate statewide were specified and their average use determined. The first was a typical fast food outlet. This commercial user had a seasonal use pattern that peaked in the winter. The second commercial user considered use about fifty percent more gas than the first category of commercial user. This was an operating dry cleaning business, not a drop-off and pick-up stop, but cleaners with operating equipment on site. This type of user did not have a noticeable heating season peak use, but instead used gas consistently year round.

Typical bills for these residential and commercial users were collected for each of the sixteen investor-owned utility rate areas in the state, and twelve of the sixteen municipal utilities in the state. In addition, typical bills for the same types of users were gathered from the four investor-owned utilities from the adjoining states—Kansas, Colorado, Wyoming, South Dakota, Minnesota, Iowa and Missouri. Each of these states has a state commission that regulates gas utilities. By limiting the out-of-state typical bill collection to the four gas utilities also operating in Nebraska, important variables affecting business practices, costs and rate design variables were controlled. The results of this comparison of typical bills are included in the following report.

Also, the experiences of municipal regulators in Nebraska who had participated in area rate proceedings and other filings were gathered and analyzed. A heavy emphasis was placed on communicating with the people who worked for the municipalities in the regulatory trenches. The objective was to do more than determine the official position of municipal groups, but to probe municipal officials and employees concerning their actual

experiences and observations regarding the municipal regulatory process. This was done through written questionnaires, telephone interviews, being available at meetings, and face-to-face conversations with these people. Every municipality that regulates gas utilities or has a municipal gas utility could easily have contributed to this stage of the report. Many thoughtful, and forthright, individuals did. They take their role as a regulator or municipal gas worker seriously. Their responses were generally predicated on how to best serve the public need for gas service in Nebraska.

Also, extensive questionnaires were completed by the gas utilities. This provided a depth of knowledge about the gas utility business in Nebraska. This information relates to sales, costs, operation and regulatory activities. This information provides a background and specific examples that appear through out the report. Also, as work proceeded on the report new issues arose—for example, the winter gas price spike, gas supplier practices and allegations regarding gas cost allocations. EFR Ltd. will continue to monitor and follow-up on these issues as needed, and inform the Committee of important developments. We will also be available to assist the Committee with other matters as it continues its work on this important issue, effective regulation of gas utilities in Nebraska.

Chapter 3

Overview of the Gas Industry

The natural gas industry, providing an important fuel to consumers, has been heavily regulated since natural gas became a widely available energy source.

The natural gas industry became important in the latter half of the twentieth century. The construction of long distance pipelines to move natural gas to consumers changed the nature of the gas industry.

The Beginnings of Natural Gas Use

In 1609, John Baptist Van Helmont discovered the gas given off by combustion and fermentation. In England, Thomas Shirley discovered natural gas in 1659. In 1812, Parliament chartered the London and Westminster Gas, Light & Coke Co. By 1850, Baltimore, Boston, New York, Brooklyn, Bristol, New Orleans, and Philadelphia had the luxury of gas lighting. Rates were very high ranging from $6 to $15 per thousand cubic feet (MCF). This limited gas use to street lighting, public buildings, some shops and industrial establishments, and the few homes of the well to do.[1]

This gas was not supplied by natural gas, but by manufactured gas. Manufactured gas plants could be located within each city and the gas produced locally using coal or oil as a

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[1] Martin G. Glaeser, Outlines of Public Utility Economics, (New York: The Macmillan Co., 1927), p. 52-3

raw material. In 1919, there were over 1000 manufactured gas utilities in the US, 57 of which were municipally owned.[2] Because the gas service from these plants generally served in only a single city or part of the city, municipal regulation reached as far as the gas mains reached.

Following the successful drilling of the first US oil well in 1859 in Titusville, Pennsylvania, a two-inch gas pipeline was run 5½ miles from the well to the village.[3] During the nineteenth century, natural gas was only used locally for street lighting in areas where natural gas had been discovered nearby. By the 1890's, electricity began to dominate lighting, but natural gas could not be transported the distances needed for heating or other uses. Natural gas was considered a waste product of petroleum production, and was either wastefully flared off or burned to make lamp black carbon. Though gas was first used for cooking in 1859[4], it was the 1885 discovery of the Bunsen burner that mixed natural gas with air that made gas an efficient fuel for space and water heating, and for cooking.

In order for consumers to have natural gas to burn, the gas had to be moved from the gas fields to the major markets often thousands of miles away. This required pipeline technology to lay pipe mile after mile, to weld segments of pipe tightly together, and to pressurize the gas in the mains. This technology was available in the 1930's. It was not until the 1950's during the post World War II boom that major pipeline construction rapidly linked major markets to

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[2] Op. cit., p. 56

[3] http://www.naturalgas.org/HISTORY.HTM

[4] Glaeser, op. cit., p. 54.

the gas fields. As these pipelines moved to the north and east, some crossed through Nebraska bringing gas to the state.

Natural Gas Usage

By 1997, natural gas was a major fuel source upon which Americans depended. Today combined residential and commercial uses amounts to 36% of total gas used with residential customers using three quarters of this usage. The Energy Information Administration (EIA) reports use by 101.5 million households in the U.S. in 1997, and 7.2 million in the West North Central states, including Nebraska, making natural gas use truly wide spread. The following table shows the main uses that millions of households have for natural gas.

HOUSEHOLD NATURAL GAS USES

	Number of Households Using Gas for:	*Percent of Households*	*Natural Gas Usage per Household with Use*
Space-Heating			
Total U.S.	53.2 million	52.4%	65 MCF
West North Central	4.7 million	65.3%	82 MCF
Water-Heating			
Total U.S.	52.8 million	52.0%	24 MCF
West North Central	4.2 million	58.3%	24 MCF
Appliances			
Total U.S.	40.8 million	40.2%	9.3 MCF
West North Central	2.5 million	34.7%	8.2 MCF

SOURCE: U.S. DEPARTMENT OF ENERGY, ENERGY INFORMATION ADMINISTRATION, "1997 RESIDENTIAL ENERGY CONSUMPTION SURVEY, HTTP://WWW.EIA.DOE.GOV/EMEU/RECS/RECS97_CE/97TBLCD.HTML

The largest use of natural gas is in the industrial market that accounts for 40% of consumption nationally. Among major industrial uses for natural gas are refiners, chemical manufacturers and ammonia producers (including fertilizer production), methanol producers, steel and aluminum manufacturers and paper mills. Many of these industries use gas as a primary source of heat, however others, particularly chemical producers, use the natural gas to produce such things as ammonia and fertilizer. Some natural gas includes on-site generation of electricity by industrial customers.

An added 15% is used for electric generation by electric utilities. Municipal and public power generating plants in Nebraska can burn natural gas. Some municipal gas utilities in Nebraska buy gas for resale jointly with the municipal power plant operated in the town and gas utilities in other towns.

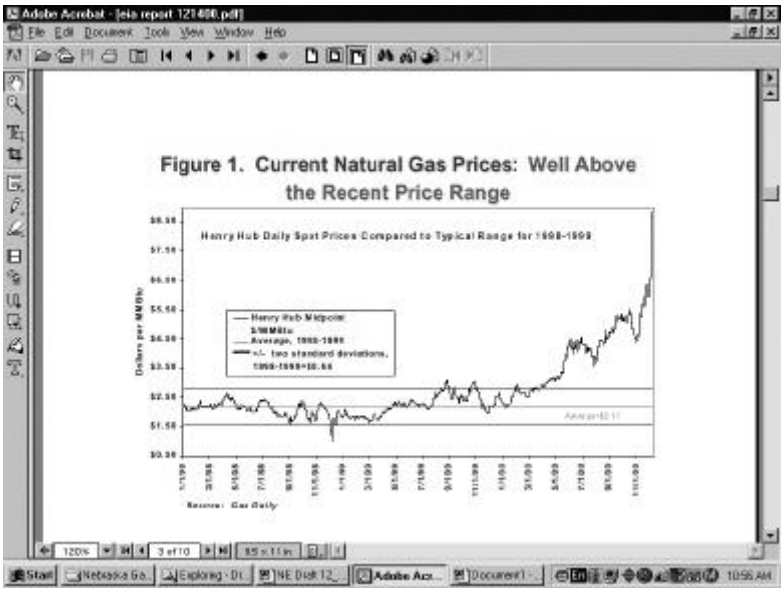
Wellhead Prices

Since May 2000, the wellhead price of natural gas has been above $4 per MCF. This is more than double the price of one year ago. The average wellhead price for all of 2000 is projected to average $3.60. But now this price has closed over $10 per MCF, the highest level in almost ten years. The Energy Information Administration (EIA) forecast for the October 2000-March 2001 heating season was $5.60 per MCF, well below the current futures prices for natural gas. Gas in storage is below the normal level, and with cold weather, rapid drawdown from this gas storage supports the higher gas prices. The price of natural gas is projected to decline by $1 per MCF as weather related demand relents in the spring, but remaining above $4 per MCF. With consumption growth higher than supply growth, the EIA expects high and volatile gas prices in the future until new supplies are on line. The average price of gas at the wellhead are not predicted to return to the historical trend until 2004. Wellhead prices are forecast to be $3.13 per MCF (thousand cubic feet) in 2020.

Retail Gas Prices Today

The forecast for this winter's heating costs was that bills would be over 40% higher than in the prior three winters. However, with colder weather and higher prices, costs could be much more than forecasted last fall. In Grand Island, NorthWestern Public Service (NWPS)

customers typically paid $2.50 per 1,000 therms—a natural gas measure of energy—each month before the recent price increase. Now the NWPS customers are paying $8.30 per 1000 therms—over triple last year's rate. In addition, NWPS reports this winter's temperatures are from 17



percent to 29 percent lower this winter than past years. NWPS reports that during last summer, when NWPS would be buying lower priced gas, prices were high so it did not pre-purchase as much gas as usual and put it into storage because NWPS hoped prices would abate. When prices did not lessen, but instead rose this fall, NWPS has had to

purchase the higher priced gas to meet demand in the four central Platte River valley municipalities it serves.[5]

A Peoples Natural Gas Co. spokesman was reported as commenting, " We suspect that customers bills will probably more than double - for the same amount of gas…."[6] The EIA had presented forecasts earlier in December showing heating cost increases for the coming winter.

Table 1: **Consumer Natural Gas Winter Heating Costs**

Average Midwest Household Consumption, U. S. Prices.				
	97-98 Actual	98-99 Actual	99-00 Actual	00-01 Est.
MCF	82.4	84.5	81.7	90.6
($/MCF)	$6.56	$6.27	$6.61	$9.21
Cost ($)	$541	$530	$540	$834

Source: EIA[7]

A normal winter heating season 11% colder than prior winter is assumed in this table. However, the climatologist at the High Plains Regional Climate Center at the University of Nebraska-Lincoln reports, "In fact, it is the second-coldest in all of the 114 years of data. ….

[5] "Higher natural gas bills putting damper on holiday cheer," The Independent," December 24, 2000, http://www.theindependent.com/stories/122400/new_naturalgas24.html

[6] "Natural Gas Prices Hit Record High Amid Cold," Lincoln Journal Star, Dec. 29, 2000, http://www.journalstar/business?story_id=347

[7] Statement of Mark J. Mazur, Acting Administrator, Energy Information Administration, Department of Energy, Before the Committee on Energy and Natural Resources, December 12, 2000.

Only one other Nov. 5 through Dec. 25 time period has been colder, and that was 1983… ."[8] MidAmerican Energy, in October warned winter heating bills could be 40 percent to 50 percent higher this winter, has now warned that heating bills could double. Coupled with cold winter weather, gas costs four to five times more than last year. Long-term purchases of some gas could have locked in lower costs to offset increases. Putting the gas in storage during cheaper low priced, off-peak summer months can have a similar effect on cost.

MidAmerican Energy said the average natural gas consumer could expect to pay about $320 to $400 more for heat from November through March.[9] Doubtless, Nebraskans will be paying much higher gas bills for heating this winter than last.

High natural gas prices do not affect just heating bills. Chemical manufacturers and electric generation use large amounts of natural gas. One of these, fertilizer, is very important in Nebraska. About 30% of the North American ammonia production was shut down in mid-December. Supplies will be short and fertilizer prices will be rising just as demand peaks in February and March.[10] Even now, ammonia fertilizer dealers will quote high prices, if supplies are available. The fertilizer manufacturers simply find it more profitable to resell their gas to be burned as winter heating fuel than to convert it into ammonia for use as nitrogen fertilizer for use on next year's crops.

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[8] "Artic blast keeps city in deep freeze," Lincoln Journal-Star, Dec. 29, 2000, http://www.journalstar.com/Nebraska?story-id=1876

[9] "Utility warns heat bills could double," Des Moines Register, December 15, 2000, p. A1, "Gas Price Warning Is Issued," Omaha World-Herald, December 16, 2000, WWW.OMAHA.COM

[10] "Price of Natural Gas Hits Boiling Point," Wall Street Journal, December 18, 2000, InteractiveWSJ.com; "Terra, Others Decide to Sell Gas Contracts," Omaha World-Herald, December 11, 2000, WWW.OMAHA.COM

Higher gas prices, colder winter weather and strong northerly winds in Nebraska add up to higher natural gas bills for consumers this coming winter. Parts of Nebraska had the coldest November in over one hundred years as a lead-in to the winter storms that came in December. The first tool consumers have to deal with these bills are budget billing programs, which allow high winter heating bills to be spread over a full year. Warned of the higher bills to come this winter, ratepayers this summer had begun to look at budget billing as an option for managing the higher heating bills of this winter. The utilities, though mailings, bill inserts, and newspaper, radio, and television publicity and ads began informing ratepayers of higher impending costs this winter.

Most hurt by these higher bills are the lowest income customers. Early in the fall, $10 million was available for assistance from the Nebraska Department of Health and Human Services and other private assistance programs, such as United Way and the Salvation Army to help eligible low-income consumers pay their heating bills. During the week before Christmas, as the Federal Government completed its budget, an additional $4 million was released for use in providing heating assistance. Late in December, even more money was released in Washington for heating assistance. To be eligible for LIHEAP assistance, income for all household members must be 116% or less of the Federal Poverty Level, the household must have resources of under $5000, and pay heating bills either directly or in rent. The benefits for this program are to be applied for at the local Health and Human Services offices.

The Salvation Army, though the MUD funded Heat Aid program assisted over 400 families through December 13, while the year before only 105 families had been assisted. Their

assistance paid out increased to $81,000 from $13,000 the year before. This organization, in the week before Christmas, was already taking appointments for January from families anticipating a need for help with their heating bills. It expects having to aid perhaps 1200 families by the end of the winter. Eligibility requirements for the Heat Aid program is limited to seniors, disabled and other low-income families who have received shut-off notices.

Alan Hersch, a Peoples Natural Gas Co. spokesman, reported Peoples is getting more calls this winter from customers seeking help to pay their bills. The Company refers them to Lincoln Action Programs and the Salvation Army. Peoples report it would not disconnect customers in such cold weather.[11]

The working poor employed but at low paying jobs living in poorly insulated inefficiently heated homes will be affected. Many may not be aware of or eligible for assistance. Another group potentially hurt will be customers with moderate, or even higher, incomes, but whose budgets are already fully committed or over extended. Budget billing is an option sought out by these customers. The utilities may have to consider forbearance of these bills by working out extended payment arrangements.

The price forecasts discussed above show that the problem of higher heating bills and natural gas costs could continue for several years. This creates a public need that in the coming years natural gas rates be no higher than necessary to cover costs. The public is in no

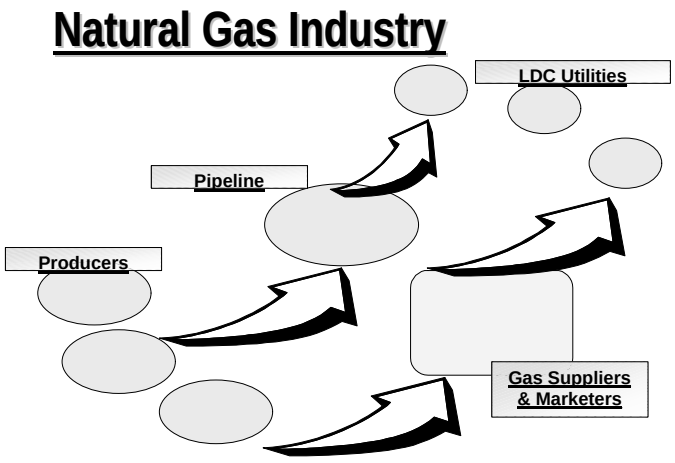
[11] "Artic blast keeps city in deep freeze," op. cit., Lincoln Journal-Star

position to tolerate extra charges in gas rates, whether by investor-owned or publicly-owned gas utilities.

The Natural Gas Industry

Several types of businesses comprise the natural gas industry. These include gas producers, pipelines, gas suppliers and marketers, and local distribution companies—local retail gas companies. The figure below displays the role these businesses perform in moving gas from gas fields to consumers.

Before any natural gas, chemically methane gas, can be removed from the ground,



exploration must find likely geologic locations for gas deposits. Then drilling of gas wells must take place. Natural gas can be found in many geological formations, and on-shore and offshore. Some formations may hold the gas more tightly making it more costly to extract the gas. Successful wells will produce marketable quantities of natural gas when completed. The span of years needed to bring wells on line after exploration explains

how supply and demand imbalances occur. Principal gas fields serving the United States are located in the southwest, the west, the Gulf Coast and western Canada.

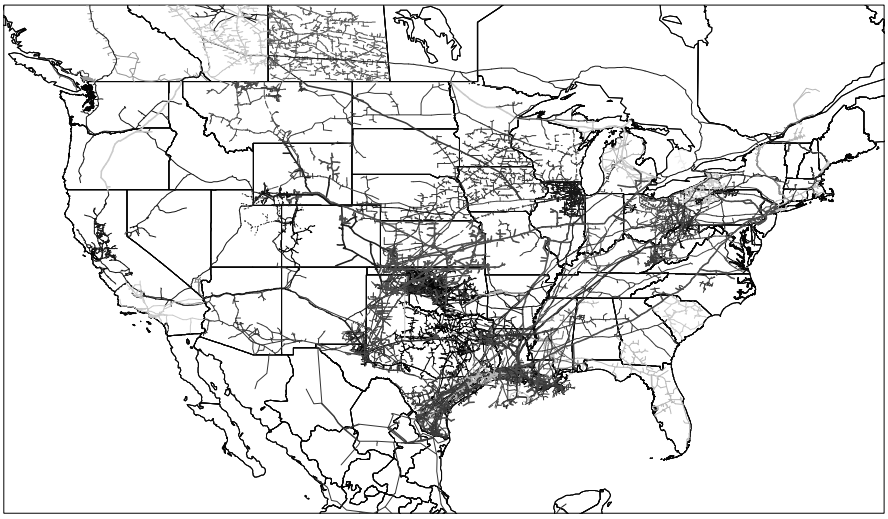


Figure 1 A Vast Network of Pipelines Traverse the US
Source: EIA

As gas is extracted from these wells, the gas producers will pay royalties to the owner of the property or the mineral rights.

The gas from these wells is then collected by use of gathering fields, piping systems laid from the wellhead to the main pipelines. After collection, the raw natural gas is processed and liquid hydrocarbons extracted from the methane to produce the natural gas the customers burn.

From the gathering fields and extraction plants, the natural gas moves into the networks of pipelines. Vast networks of pipelines provide interstate transportation of natural gas

throughout and into the United States. In addition, such states as Texas and Louisiana have significant intrastate pipelines moving gas for use within the respective states.

These pipelines move gas from the major natural gas producing areas represented on the following map to the major centers of usage. The movement of gas into Nebraska comes

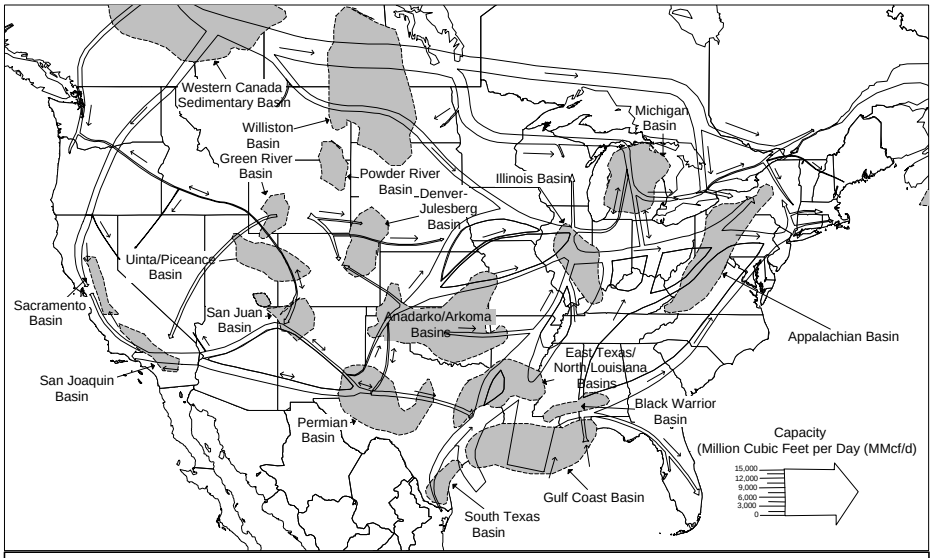
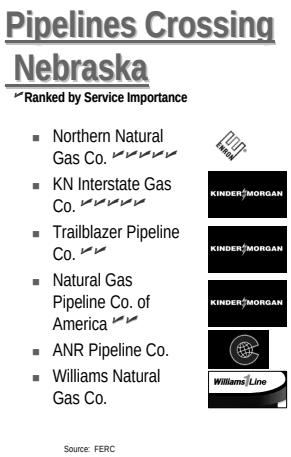


Figure 2 Pipelines Move Gas From Producing Basins to Gas Markets in Great Quantity
Source: EIA

from gas predominately produced in the southwest and west along pipelines traveling to the urban and industrial centers in Illinois and Michigan. The above map represents these producing centers as well as the pipeline capacity and flows of gas throughout the United States.

Getting the Gas to Nebraskans

Several natural gas pipelines traverse Nebraska. These include the following six pipelines certificated by the Federal Energy Regulatory Commission, though only four make significant sales in Nebraska. Another two, ANR and Williams Natural Gas Co. only skirt the corners of the state. Three of the remaining four pipelines—KN Interstate Gas Co., Natural Gas Pipeline Co. of America, and a 2/3 interest in Trailblazer Pipeline Co.—are a part of the Kinder-Morgan Co. The other pipeline, Northern Natural Gas Co., is owned by Enron, which also owns the remaining interest in the Trailblazer Pipeline.



Nebraska Gas Industry

The accompanying maps display the parts of Nebraska served by the Northern Natural Gas Pipeline, the KN Interstate Pipeline, the NGPL pipeline, and the Trailblazer Pipeline in Nebraska. Also shown are maps of ANR and Williams Gas Pipelines that are much less important to Nebraska's gas supply. These pipelines supply the four investor-owned gas utilities operating in the state as well as the sixteen publicly-owned gas utilities serving communities in Nebraska.

The first map (in the left upper corner) closely corresponds to the Peoples Gas Co. service territory. Peoples serve some communities from the KNI Pipeline immediately to the west of the Enron (Northern Natural Gas Pipeline) territory.

The main delivery from the Natural Gas Pipeline (NGPL) is to the municipal gas utility in Nebraska City. It also provides a second pipeline supplying gas to Peoples Gas Co. in the Lincoln rate area.

MidAmerican Energy gas sells gas in South Sioux City and Dakota City in northeast Nebraska. Gas is transported to these two towns through the Northern Natural Gas Pipeline.

Table 1

Enron Gas Pipeline Delivery Points

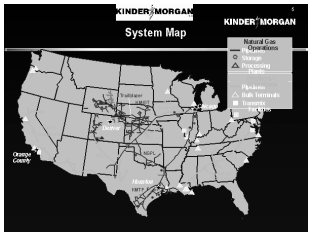
Source: Enron

Enron Gas Pipeline

Source: Enron

Kinder Morgan Pipelines

Including KNI Pipeline, NGPL Pipeline and 2/3 Interest in Trailblazer Pipeline



Source: www.kindermorgan.com

ANR And Williams Nat'l Gas Pipelines Skirt Nebraska

ANR

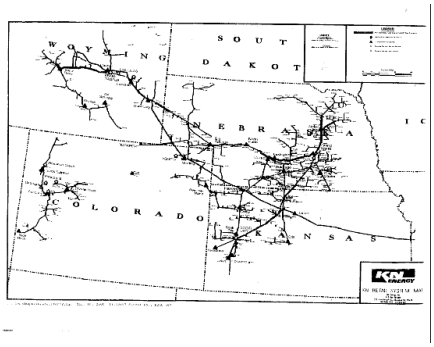
Williams

Source: www.coastalcorp.com/www.williams.com

The North Western Public Service Company receives delivery via the KNI pipeline delivery points to Grand Island and Alda, Kearney, and North Platte. The KN retail gas system is shown in the following map.

Table 2

KN Retail System



Source: KN Energy, FERC Fm. 2, Dec. 31, 1999

The map on the following page shows the general outline of the gas service territories served by the investor-owned utilities in Nebraska listed below. In addition, this table lists the towns and cities that are served by publicly-owned municipal utilities. In the map, it is well to remember that the customers served are within or immediately adjacent to town or city municipal limits. Rural Nebraskans and residents of towns or cities not in proximity to a pipeline delivery point usually do not have gas service, though the map encompasses the area.

Table 3

Local Distribution Gas Utilities

- Investor Owned Utilities
  - Peoples Gas Co.
  - KN Energy Co.
  - North Western Public Service Co.
  - MidAmerican Energy Co.
- Publicly Owned Utilities
  - MUD (Omaha)
  - Fremont
  - Nebraska City
  - Hastings
  - Falls City
  - Wahoo
  - Central City
  - Lyons
  - Alma
  - Pender
  - Ponca
  - Stromsburg
  - Superior
  - Stuart
  - Schuyler
  - Wisner
  - Neligh*

Uniform rates are not set for all the customers of each company's service territory in single rate proceedings. Instead, a series of rate areas are set up under the Municipal Natural Gas

Regulatory Act in Nebraska. Each utility company's service territory is broken down into several rate areas. Each rate area will have a separate rate filings, and subsequently a separate area rate proceeding. Sixteen separate rate proceedings may be necessary over a period of years if rates are to be changed across the entire state.

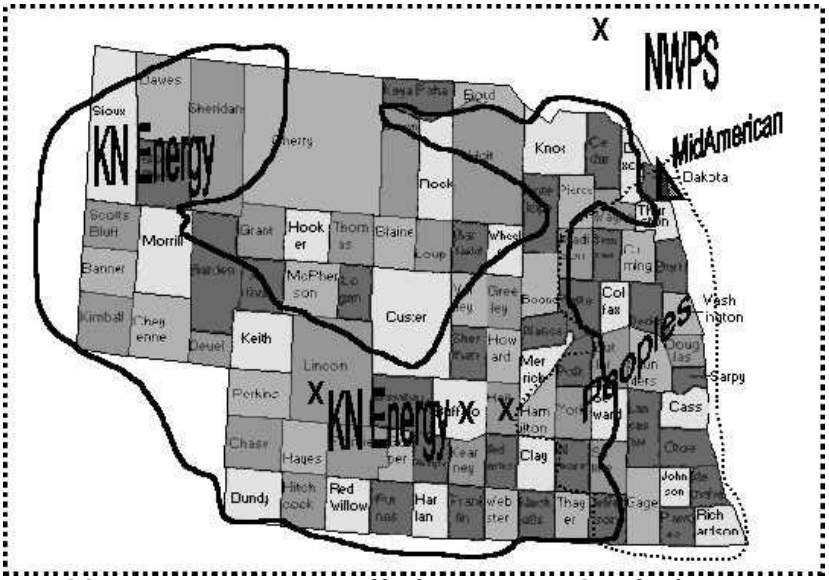


Figure 3 Service Territories Encompassed by the Four Investor-Owned Utilities

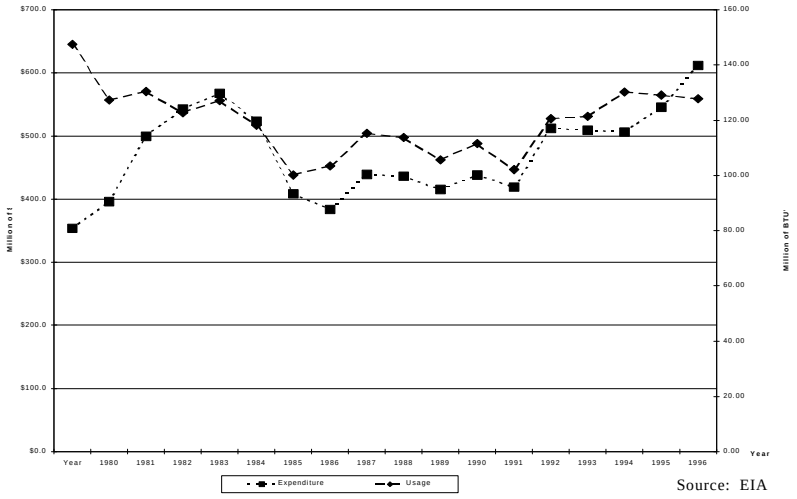
CHAPTER 4

Nebraska Natural Gas Prices

Nebraska's natural gas prices, compared with adjoining states, are high for some out state municipal and investor-owned utility customers

Natural gas usage in Nebraska fell during the early years of the 1980's, while expenditures

Nebraska Natural Gas Expenditure and Usage

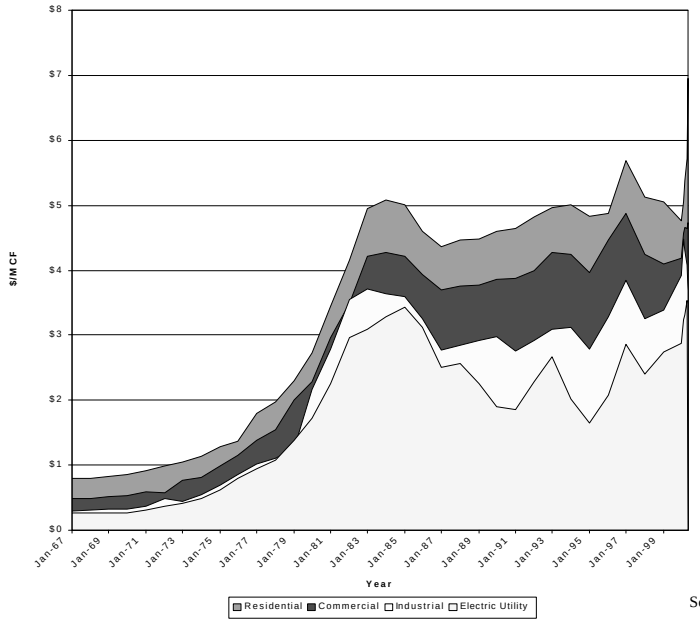


Source: EIA

rose. From 1985 through 1991, expenditures and usage were level. But since 1992, both expenditure and usage have risen at the same pace.

This pattern accompanied sharply rising prices of natural gas in the early 1980's followed by three years of price declines until a period of level rates began in 1988. The typical pricing pattern shows residential customers paying higher prices than other users, with commercial

Nebraska Gas Prices by Type of User

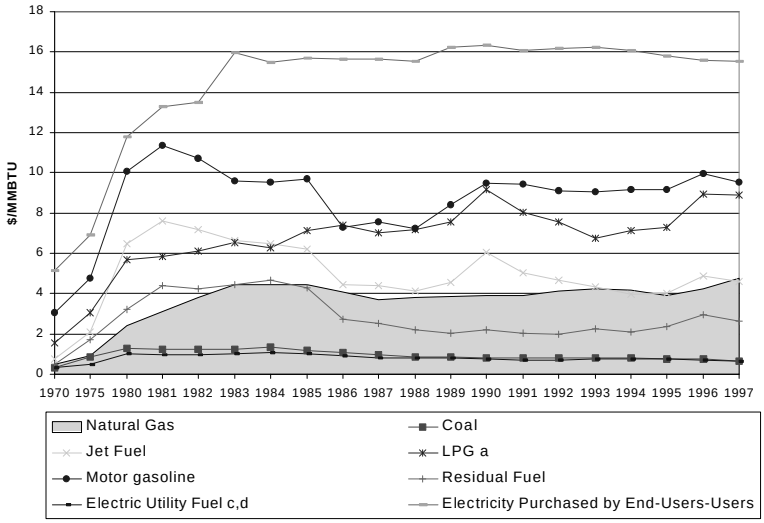


Source: EIA

uses being priced higher than industrial and electric generation, which had the lowest price. Natural gas burned for electric generation also had the most rapid growth. The divergence between small and large customer's rates rose in the 1990's as Federal policy shifted nearly all pipeline fixed costs onto small firm users, mostly as residential and commercial customers. Furthermore, with adequacy of supplies, natural gas became readily available to industrial and electric generation customers at reasonable prices. The consequence has been that natural gas demand has risen to the level of available gas supplies.

Natural gas has consistently been cheaper than alternatives in Nebraska. Until recently, the price of natural gas was quite stable. On the basis of energy content, natural gas was considerably cheaper than propane, gasoline, and especially electricity.

Nebraska Energy Prices



Source: EIA

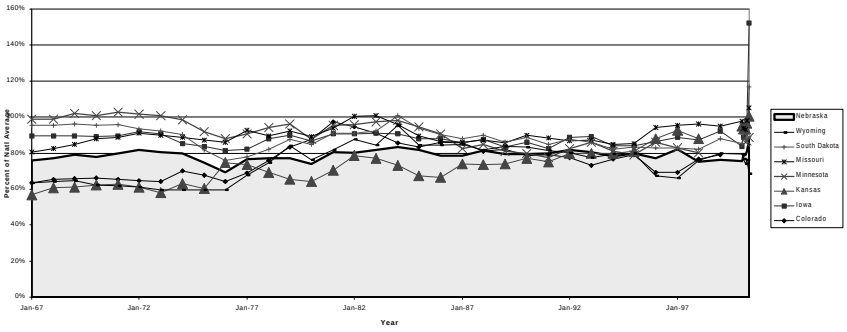
Nebraska's natural gas prices were compared to those charged in adjoining states. First estimated average price data compiled by the Energy Information Administration (EIA) is examined. Then typical bills for residential and commercial customers of each gas utility in Nebraska are considered. The EIA publishes average prices that it estimates for each state.

Below residential prices are looked at first. Comparing each state's price to the national average, the price for each state, including Nebraska, is shown as a percent of the national average. Nebraska's residential gas price has been close to 80% of the national average for many years. Nebraska customers should have prices below the national average since they are one to two thousand miles closer to the major gas fields than major gas markets on the east and west coasts. Also, the higher winter heating loads allow the fixed costs of gas supply to be spread over more sales than in the warmer states.

It is noteworthy that residential natural gas prices do not show any lowering after the Municipal Natural Gas Regulation Act was passed in 1987. Residential rates in Nebraska remained the same, whether measured relative to the national average price, or ranked relative to other adjoining states.

Nebraska Residential Gas Prices

compared with adjoining states' prices (% of nat'l avg.)

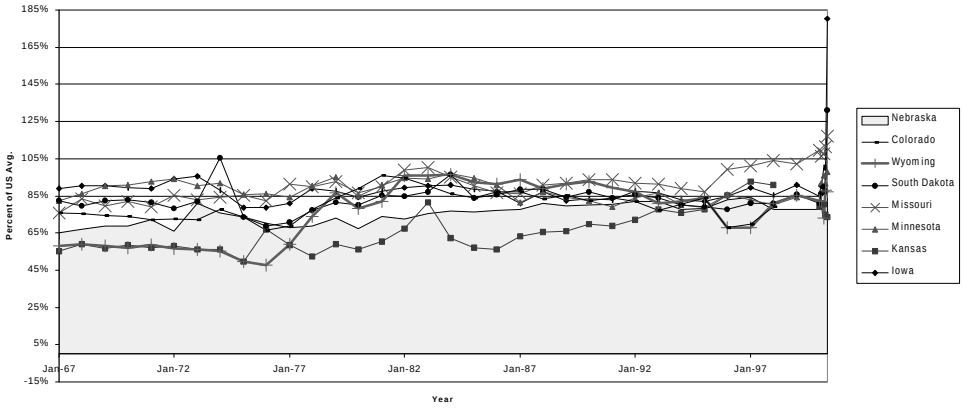


Source: EIA

The price commercial customers pay for natural gas has risen in Nebraska relative to those in the U.S. By 1987, rates had risen to 80% of the national average. Relative to adjoining states, the commercial gas price has been changed little since 1987.

Nebraska Commercial Gas Prices

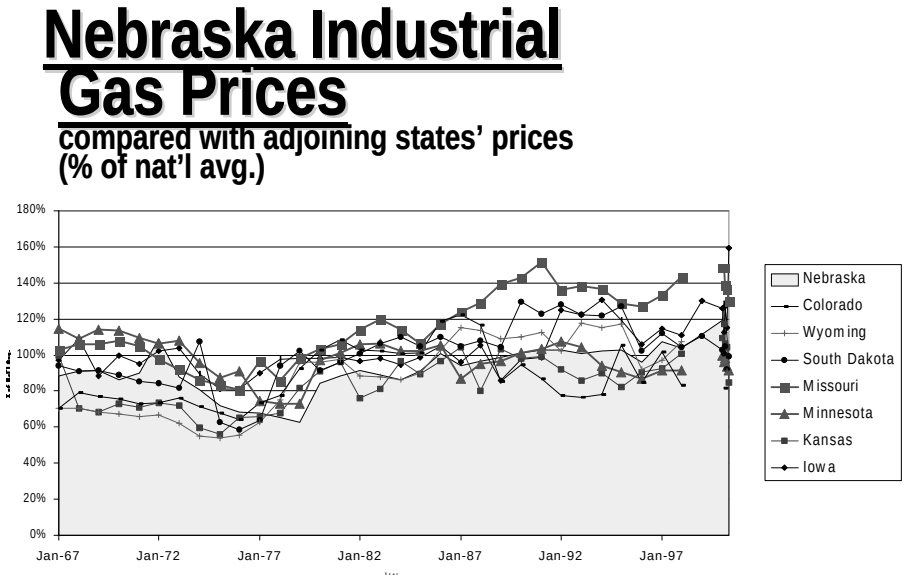
compared with adjoining states' prices (% of nat'l avg.)



Source: EIA

The extreme right observation in the table, though a bit hard to see there next to the axis, shows the price spike during the winter of 1999. Were this winter's prices shown, a further sharp increase would appear.

Industrial gas prices in Nebraska have perhaps the clearest tale to tell. They have risen to well above the national average and one of the highest regionally. Before 1987, industrial



Source: EIA

rates in Nebraska were consistently below the national average price. However, rising rates beginning in the 1970's moved the state's industrial gas prices to 100% of the national average by the end of the 1980's. And by the end of the 1990's, industrial gas prices had

risen further, to 120% of the national average. Nebraska's industrial rates, once among the lowest among adjoining states in the late 1970's and early 1980's, have now risen to one of the highest.

One explanation might be that to the extent residential and commercial rate increases were slowed by municipal rate regulation, revenue increases were shifted to the area of least resistance, industrial rates. Alternatively, other states may have set industrial rates lower to recognize liberal access to transportation, thus gaining a rate advantage for other states. This rising industrial rate in Nebraska may have increased the incentive for industrial customers to purchase their own gas supply from marketers, which they could transport, their gas through the pipelines and LDC's mains at transportation rates. These industrial users would no longer pay the industrial rate. The result would be to have lower volumes to spread fixed costs over and to bill all customers continuing to purchase gas from the utility more.

The Energy Information Administration, using a sampling procedure, estimates the average rates shown above. This procedure systematically includes the largest gas companies in a state, which means Peoples Gas Co., KN Energy and MUD are assured inclusion for Nebraska in the study. Then EIA adds information gathered from at least two, and perhaps three, smaller LDC's, perhaps investor-owned, perhaps publicly-owned. EIA then extrapolates, based on statewide characteristics, to make the average rates representative of the entire state.

The EIA estimation procedure means investor-owned utilities are averaged in with publicly-owned utilities, and large LDC's with small LDC's. As a part of this study, typical bills

were obtained for residential and commercial customers. These were provided by the four investor-owned utilities as well as most of the publicly-owned LDC's. The typical bills from other states come from these same four investor-owned utilities. Four of the municipal publicly-owned LDC's either failed to respond after repeated contacts, or neglected to include PGA information needed to complete the typical bill calculation.

These typical bills were calculated for a residential customer using 1000 ccf's[1] of natural gas from July 1999 through June 2000. This residential customer had a markedly distinct heating load resulting in a much higher winter usage. This usage was adjusted to consider a normal winter heating season since the winter included was warmer than normal by about 10%. The commercial customers were represented by one using 10,000 ccf's and another using 15,000 ccf's. These usages were selected to represent a typical fast food store, and a dry cleaning business operating cleaning machinery at the site. These were selected because they could exist statewide. The fast food business had a winter peaking usage, though not as marked, like the residential user. However, the dry cleaner had very little, if any, added winter heating usage.

Month-by-month usage was set forth, and twelve monthly bills calculated. These monthly calculations were made using the actual gas rates, including purchased gas clause charges, in effect for each month.

[1] Ccf = one cubic feet

The following table compares the typical bills charged by investor-owned utilities including Peoples Gas Co.'s three rate areas, KN Energy's 11 rate areas and one rate area each for NorthWestern Public Service Co. and MidAmerican Energy. The rates were compared with an average for those charged by these same utility companies in the states of Wyoming, Colorado, Kansas, Missouri, Iowa, Minnesota, and South Dakota.

Table 1 Investor Owned Utilities Rate Comparison (Typical Bills for Period July 1999 through June 2000)

State	Area	Residential (1000 ccf's)	Small Commercial (10,000 ccf's)	Large Commercial (15,000 ccf's)
Nebraska	***Avg.***	***$679***	***$6,064***	***$8,809***
	Metropolitan	$558	$5,175	$7,756
	Non-Metro.	$694	$6,176	$8,941
Other States	***Avg.***	***$581***	***$5,191***	***$7,667***

The following table shows that only the rates in the Omaha and Lincoln Metropolitan Areas are consistent with those of other states. This undoubtedly reflects competitive pressure from MUD in the Omaha area, and the availability of gas supplied from both Northern Natural Gas Pipeline and Natural Gas Pipeline in the Lincoln service area. Gas rates in outlying areas of Nebraska are markedly higher than those of the adjoining states. The rates in adjoining states include service to outlying areas in those states also.

Table 2 Investor Owned Utilities Rate Comparison (Percent of Nebraska State Wide Average)

State	Area	Residential (1000 ccf's)	Small Commercial (10,000 ccf's)	Large Commercial (15,000 ccf's)
Nebraska	***Avg.***	***100%***	***100%***	***100%***
	Metropolitan	82%	85%	88%
	Non-Metro.	102%	102%	101%
Other States	***Avg.***	***86%***	***86%***	***87%***

The following table may the most telling. It shows clearly that Nebraska's investor owned utilities regularly charge regulated customers high bills. This table compares the average typical bills in Nebraska to the highest typical bill from all the adjoining states. Nebraska's typical bills are virtually as high as the highest typical bill in theses adjoining states. In fact, the average residential and small commercial rates are slightly higher than those typical bills for the same services in adjoining states.

Table 3 Investor Owned Utilities Rate Comparison (Typical Bills for Period July 1999 through June 2000)

State	Area	Residential (1000 ccf's)	Small Commercial (10,000 ccf's)	Large Commercial (15,000 ccf's)
Nebraska	***Avg.***	***$679***	***$6,064***	***$8,809***
	Metropolitan	$558	$5,175	$7,756
	Non-Metro.	$694	$6,176	$8,941
Other States	***Maximum***	***$692***	***$6,107***	***$9,140***
	Minimum	***$496***	***$4,387***	***$6,545***

Municipal gas utilities in Nebraska likewise have high gas rates. The residential and small commercial typical bills for Nebraska municipal utilities exceed the average investor owned typical bills in the adjoining states. However, they are only about fifteen percent lower than the average investor-owned gas company typical bill for the same customer class in Nebraska. Outside the Omaha area, municipal rates are only about ten percent lower than for the state-wide investor-owned average. Municipal gas utilities have several cost advantages compared to their investor-owned counterparts. They are not required to pay income or property taxes. They do not have to make profits for investors. They are eligible for tax-exempt debt financing. Many municipal governments use these advantages to convert a substantial share of revenues into the municipal general fund. MUD pays 2% from its Omaha customers to the City of Omaha, one of the smallest rates. Other municipalities took up to 7% of revenues from the gas utility for general municipal purposes. As shown in the following table, out state municipal utilities, compared on an equal footing, have nearly as high gas rates as do the investor-owned utilities in the state.

Table 4 Municipal Utilities Rate Comparison (Percent of Nebraska State Wide Average)

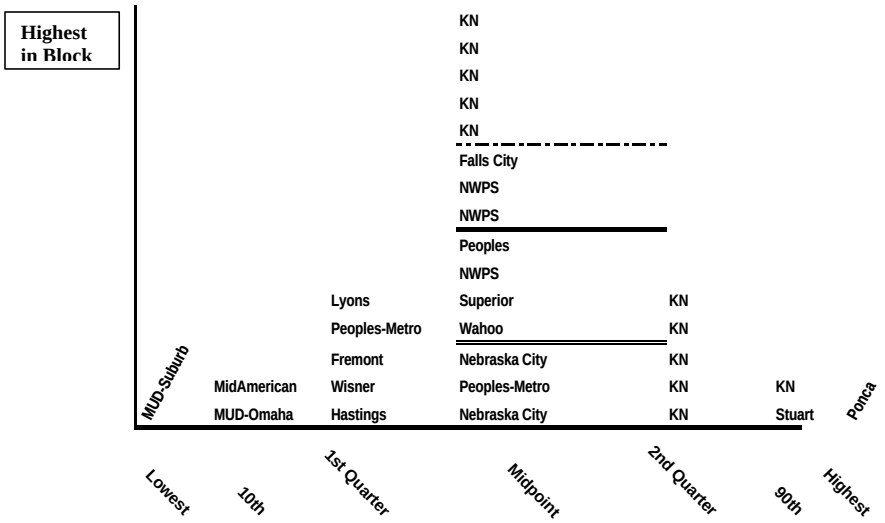
State	Area	Residential (1000 ccf's)	Small Commercial (10,000 ccf's)	Large Commercial (15,000 ccf's)
Nebraska Muni's	***Avg.***	***$584***	***$5,208***	***$7,226***
	Metropolitan MUD	$463	$4,068	$6,016
	Outstate Muni's	$606	$5,415	$7,465
Investor-Owned Utilities				
Other States	***Avg.***	***$581***	***$5,191***	***$8,941***
Nebraska	***Avg.***	***$679***	***$6,064***	***$8,809***

The following table shows the relative ranking for the typical bills provided by both municipal- and investor-owned utilities. The municipal utilities are listed by the municipality name (MUD appears twice, once showing the in-Omaha bill with the 2% municipal payment, and again showing the suburban bill without the 2% payment.) The investor-owned utilities are labeled—KN Energy (KN), Peoples, MidAmerican and Northwestern Public Service Co. (NWPS). The percentiles ranking for typical bills go from lower to higher moving from left to right along the bottom of the chart. Similar bills were grouped with in each block, but moving from the bottom of the block to the top advances from lower to higher typical bills within each block.

As a comparison with the earlier charts, the state-wide average of both IOU and municipal bills would lie just above the Falls City bill in the middle block (at the dashed line); the statewide median of both IOU and municipal bills just above the Peoples bill in the middle

column (at the heavy line); and the average IOU's bill for adjoining state above the Nebraska City line (at the double line).

Nebraska Gas Utility
Residential Typical Bills



Ranked from Highest to Lowest

Some discussion of factors affecting ranking of the residential and commercial bills may be useful. Two of the three highest residential bills in the state are in the municipalities of Ponca and Stuart. Both are very small—Ponca with 375 customers, 320 that are residential and 55 commercial; and Stuart with 224 customers, 191 residential, 29 commercial and 4 interruptible irrigation customers. The fixed pipeline reservation charge paid to move natural

gas into Ponca over the Northern Natural Gas pipeline is very large for such a small natural gas utility causing the bills to be very high. Ponca has a purchased gas cost recovery rate. The Village of Stuart acquired the village's gas utility from KN Energy in 1992. Its small size, KN Energy pipeline charges and debt service payments account for Stuart's high bills. Stuart has no automatic cost recovery clause. (An interesting observation noted is that the rates are higher than when the municipality purchased it. Also quite unusual, the commercial rate in Stuart exceeds the residential rate.)

The remaining highest typical residential bills originate from KN Energy's rate area. A comparison of KN Energy's typical bills in western and southwest Nebraska with adjoining KN Energy service territories and served by KN's pipeline in adjacent parts of Wyoming and Colorado was revealing. Nebraska's typical bills were significantly higher than in the other states, both of which have state commission regulation of gas rates. KN Energy's FERC Form 2 report showed the retail gas business paid substantial costs for business services shared among several affiliates and divisions of Kinder-Morgan.

Falls City's Utilities serves over 2200 customers, including two thousand residential customers, in extreme southeastern Nebraska. Falls City's bills include a 7% charge by the municipality in lieu of taxes—a 5% franchise tax plus a 2% economic development charge, which adds to its typical bills. This amounts to about $70 per year per customer. Falls City purchases gas through the Nebraska Public Gas Agency; a publicly-owned gas marketer and transports it over the Williams Bros. Pipeline, a pipeline serving few areas in Nebraska. It has a lower than average monthly customer charge of $6. It charges higher winter gas rates than

summer rates. This was adopted to promote energy conservation at the behest of an energy-consulting firm that recommended a decrease in summer rates in 1995 to accomplish this. This cost of service study shows the residential rates, when designed, was known to be higher than the rates of other utilities in the area. The usefulness of the higher winter rate as a conservation tool is probably very weak as an economic matter because residential heating use of gas during the winter is probably one of the least price sensitive uses for gas. The usefulness of the higher winter rate as a financial tool cannot be in doubt—it no doubt yields a substantial revenue gain to the municipality. The utility also has a purchased gas recovery rate that was retained during falling as well as increasing gas costs. This certainly is more fair than the approach taken by some municipalities that had dropped purchased gas recovery clauses when rates were declining, but are now reinstating them as gas costs rise.

The above average rates for the rate areas of NorthWestern Public Service Co. in central Nebraska reflect pipeline transportation costs via KN's pipeline affiliate. The western tier of the Peoples Gas Co's rate area 3 is likewise served by KN's pipeline affiliate, while the eastern two-thirds is served from the Northern Natural Gas pipeline. The KN I pipeline rates are higher than those charged by the Northern Natural Gas pipeline.

Superior Utilities has some 1200 gas customers, one thousand of which are residential customers. Its contribution to the city amounts to about $37 per year from each customer, some 5% of revenues paid in lieu of taxes. Like Falls City Utilities, Superior Utilities also has higher winter rates than summer rates, but a higher $9.35 monthly customer charge year round. It has a purchased gas recovery mechanism to automatically change rates with

changes in wholesale gas costs of the utility. It purchases its gas through the Nebraska Public Gas Agency.

Superior Utilities received a qualified opinion in audit for the fiscal year ended September 30, 1999. The audit stated the utility plant and contributed capital amounts on the utility's financial statements could not be verified in their entirety. This audit reported,

> Due to a limitation in the scope of my engagement, I was unable to satisfy myself as to the costs of the utility plant and contributed capital as of September 30, 1999, amounting to $10,487,828 and $1,648,308 respectively, and the related depreciation expense of $323,296. Further, I did not observe the beginning physical inventory count and did not later recount or reconcile the inventory. Finally, beginning detailed accounts receivable records were not available for audit and I was not able to satisfy myself to the accuracy of the totals presented.
>
> Because of the material impact of the items in the paragraph above, I am unable to express an opinion on the financial position of Superior Utilities as of September 30, 1999, and the results of its operations and cash flows for the year then ended.
>
> . . . .
>
> However, I noted certain immaterial instances of noncompliance that I have reported to the management of Superior Utilities, Superior, Nebraska, in a separate letter date January 4, 2000.
>
> . . . .
>
> However, I noted other matters involving the internal control over financial reporting that I have reported to the management of Superior Utilities in a separate letter dated January 4, 2000.[2]

The typical bills for commercial customers generally are ranked like those of the residential customers except that two municipal utilities with low residential bills, Lyons and Wisner, had higher commercial bills. But the contrast in rate making policy in these towns is marked,

[2] Marlan V. Watson, CPA, "City of Superior Utilities, Superior Nebraska, Financial Statements and Supplementary Information with Independent Auditor's Report For the Year Ended September 30, 1999," dated January 4, 2000.

probably, in part, designed to keep residential rates low. Lyons has a $10 per month customer charge for residential customers, but a $150 per month customer charge for commercial customers. In 1990, Lyons rebuilt its system of gas mains, a capital expenditure for which it continues to pay debt service. Wisner, with 510 gas customers, pays the city 5% of revenues in lieu of taxes. Wisner also has a purchased gas adjustment clause. Residential customers are charged a customer charge of $6 per month, while commercial customers pay $10 per month. Also, the energy charge for the commercial customer is slightly higher than for the residential customer, an unusual rate difference. Usually a higher customer charge is a trade-off for a lower gas supply cost.

Four municipalities did not provide useful typical bill information. These included Alma and Central City, which provided base rates, but not purchased gas adjustment rates and other data needed for calculation of the typical bills. The towns of Pender and Stromsberg never did respond to requests. Neligh's status as a municipal gas utility was too undetermined during the preparation of this study to be reflected in its results.

Consistently lower typical bills appeared for the municipal gas utilities in Omaha (MUD), Hastings, and Fremont. Both residential and commercial rates were below the average both in Nebraska and compared with out-of-state investor-owned gas utilities. The Peoples Gas Co. rates in the suburban Omaha area are among the lowest in the state, as reported to me by one municipal official, because of the service territory competition with MUD.

The causes of rate differences between Nebraska investor-owned utilities and the same operations in adjoining states, and between municipal utilities in Nebraska and investor-owned utilities in Nebraska and in adjoining states appear in the following list.

Causes of Rate Differences

- Gas Costs Differ
  - Gas Supplier Costs
  - PGA Timing
  - Gas Purchasing Stategies
- Pipeline Transport Charges Differ
- Distribution and Operations Systems Differ
- Taxes and Margins Differ
- Debt Service Obligations
- Strong Limits on Rates Set By State Commissions

Figure 1

Many of the responses from the smaller municipal gas utilities made claims of local control being a paramount concern. However, beyond having a local board of utilities controlling its local gas plant operating and maintenance employees, and basic meter reading and rudimentary billing, the local municipality does not often have the expertise, power or staffing to control its gas supply, rate design or financial accounting, reporting or management. The smaller towns need to rely too heavily on their gas supply marketers, even to the point of having the gas marketer compute its rates or monthly purchased gas rate. Some of this

difficulty is handled by cooperative or joint purchases, either with the municipal electric department, or through organizations such as PACE. But the latter arrangement still means yielding local control to outside, larger forces. The municipalities, in some instances, relied upon an outside rate consultant to prepare even an elementary rate study. In several cases, the municipal utilities did not have staff able or willing to provide certain basic data—like the number of customers. Much of the detailed information EFR Ltd. requested is data necessary for a utility, whether investor-owned or publicly-owned, to determine the revenue requirements and design rates fairly.

Many basic problems are left unresolved by local control. One significant cause is that major problems facing the gas market simply exceed the reach of the municipal authority. They have to deal with gas marketers and major pipelines. They have to design gas rates attractive to prospective industry, business and residents, while at the same time collecting from current customers the costs of service. The municipal gas utilities, as well as Peoples Gas, show little willingness to face the increasing complexities of offering a consumer choice program.

Those most able were those in larger towns and cities, especially when coupled with electric and/or large water systems. These larger organizations could afford the staffing to prepare financial and sales analysis, and to put meaningful rate designs into effect. Smaller towns' range of effective operation was limited to operation and maintenance of a piped distribution system, meter reading, and rudimentary post card billing systems. This lack of staffing and expertise at small gas utilities explains why rate designs, such as customer charges and

usage blocks varied very widely among municipal gas utilities. In another, more costly aspect, the small size of some towns mean the utility must cope with pipeline reservation charges, a fixed cost, that are disproportionately large relative to the sales to their customers. The study revealed a limited reach for local control by the small municipality. The problem is that much of the gas utility business is simply too complex to be effectively controlled locally. The economic and federal regulatory changes are simply too broad for the local gas utility board and municipality to cope with. Gas marketing and pipelines are big businesses; the small go-it-on-your-own municipal gas utility is not.

Chapter 5

Nebraska Municipal Regulation

Nebraska's unique municipal regulation of IOU gas utilities is a very weak form of regulation

Nebraska is the last remaining state where the municipality, though its grant of franchises, has plenary power over natural gas rates. Texas is the only other state with a form of municipal regulation. However, the decisions may be appealed to the Texas Railroad Commission if objected to by the utility. Then the Commission takes new evidence while rehearing the rate case.

Municipal Natural Gas Regulation Act

The 1987 Nebraska Municipal Natural Gas Regulation Act consolidated the investigative and hearing process of the municipal rate determination process across an area wide, instead of city-by-city, proceeding. No longer was it necessary for every municipality to duplicate rate review procedures. Groups of municipalities within areas outlined by the gas companies could band together to jointly investigate the rate filings and hold hearings. Further, the Municipal Natural Gas Regulation Revolving Loan Fund was established, to be administered by the Nebraska Energy Office, permitting the funding of the municipal rate proceeding. The

> "proceeds may only be used for the costs and expenses incurred by the municipality to analyze rate filings and establish area wide rates and to finance litigation costs of any appeals. Such costs and expenses may include the cost of rate consultants, attorneys, hearing officers, preparation of transcripts and hearing records provided

> for by the Municipal Natural Gas Regulation Act, expert witnesses, and any other necessary costs related to the conduct and administration of the hearing…."[1]

Subsequently,

> All loans made under this subsection shall be paid by the utility to the Governor's Policy Research Office within thirty days of being billed by the office. The utility may recover the amount paid on a loan through a special surcharge on customers which may be billed on the monthly statements for up to a twelve-month period to be shown on the statements as a charge for rate regulation expense.[2]

Nebraska's Municipal Loan Fund Is Empty

	Municipal Regulatory Loan Fund
Cash on Hand	$-0-
Loan Payment Not Repaid	$390,000
Unfunded Outstanding Regulatory Costs (10/27/00)	$251,335

Source: KN Energy and Peoples FERC Form 2

Figure 1

The Revolving Fund presently has a deficit leaving no funds available to finance any municipal regulatory activity should a case be filed in any rate areas. This deficit represents expenses incurred in a KN Energy proceeding initiated by western Nebraska municipalities. This municipal rate action has been appealed to the Lancaster County Court.

■

[1] Nebraska Code §19-4617

[2] Nebraska Code §19-4617 (b)

KN Energy has contested the requirement that it reimburse the fund. This refusal has been challenged by the State of Nebraska. The Nebraska Attorney General has begun a suit to recover the unpaid monies. The lack of Revolving Fund monies leaves expenses unpaid as the municipalities defend their rate action on appeal. Even if the fund were to be reimbursed or restored promptly by the utility, which there is no reason to believe will occur, the Loan Fund appropriations for the current year already would be nearly exhausted. The Revolving Fund needs prompt action to lift this regulatory interruption.

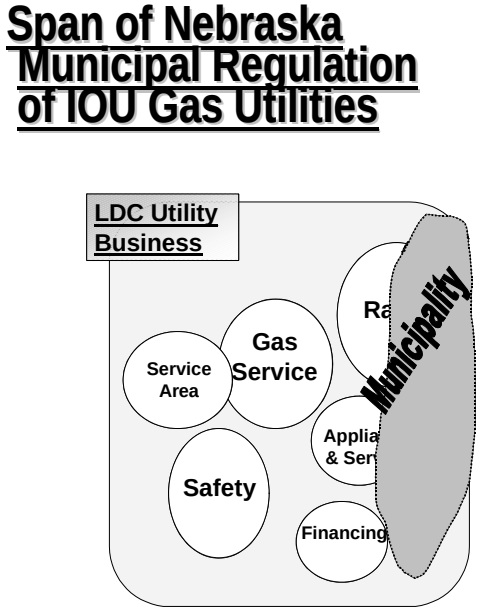


Figure 2 Nebraska's Muncipal Regulation Is Very Limited

Public utility regulation frequently extends into arenas other than rates. However, the regulatory oversight in Nebraska is very limited. Beyond the franchise itself, the regulatory authority over rates has been limited to distribution costs, with gas supply cost review generally excluded. The fair competition requirements imposed are also minimal, requiring

only an affidavit that the utility is not subsidizing the sale of appliances or services. No mechanism exists to police compliance with the rates or the fair competition statutes.

Furthermore, rate regulation is sharply circumvented in Nebraska. Rate regulation is limited to the rates on sales to residential and commercial customers served within municipal city limits. The rates paid by large commercial and industrial customers, and customers outside municipalities, such as agricultural and rural customers, receive no regulatory review in Nebraska.

The Nebraska Municipal Natural Gas Regulation Act further limits oversight of residential and commercial rates**.** In practice, the oversight by municipal regulation has been limited to the delivery or distribution costs within the municipal boundaries. The portion of rates attributable to the cost of gas supply has not been largely ignored. The municipal involvement over gas supply costs has been ministerial, rather than regulatory, in Nebraska. This seems to arise first from the utilities refusal to concede jurisdiction exists, while at the same time, including gas costs and purchased gas adjustments in the municipal rate ordinance. Second, the municipalities' consultants have not pressed the issue of gas supply costs. A recent example of this arose regarding Peoples Natural Gas Co. gas procurement policy, as no oversight body exists in Nebraska. A second example is the refunds from gas producers to local distribution companies from the Kansas Ad Valorem Tax. Though customers in other states will be receiving refunds, Nebraska customers were not represented at the table and no mechanism exists to ensure the refunds are passed through from the local distribution utilities to the ratepayers.

Other Regulatory Powers

In Nebraska, some of these other regulatory functions are assigned to state agencies, some to municipalities and several left unregulated. The Nebraska Public Service Commission has very limited jurisdiction. The PSC can designate service territories in the Omaha suburban area when MUD and Peoples Natural Gas Co. cannot resolve conflicts regarding which company gets to provide gas service to certain customers or developments. This authority is very new only three disputes have arisen, with none requiring a formal proceeding to be resolved.

Span of Public Service Commission Control

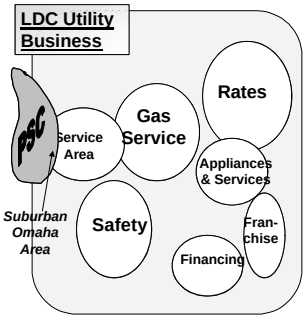


Figure 3 Nebraska's PSC Has Only A Minimal Regulatory Role

The Nebraska Public Service Commission was, originally, a railroad commission, that was transformed to motor carrier and telephone regulation. It has no regulatory history or expertise in the energy industries, such as electricity or gas. Regulation in the energy industries would require different regulatory directions and goals than does telephone regulation.

Another public power used by gas utilities is the right of eminent domain, that is, the right to take private property for a public purpose. The private property owner is compensated for the fair market value of his property loss. This derives from ancient right of the state, the king, to use private property for public thoroughfares. In Nebraska, the Code vests the power of

eminent domain with the gas utility itself, under the right of review of the court. In some jurisdictions, the regulatory commission must determine that the gas utility's use for the project will fulfill a public convenience and necessity before exercise of the right of eminent domain. In other states, the statutes will directly confer the determination of public convenience and necessity on the utility, subject only to court review.

Another area of gas utility regulation in Nebraska rests with the Department of Transportation under the State Fire Marshall. The State Fire Marshall regulates safety for the state's gas pipelines and mains. This is consistent with the Federal designation of the U S Department of Transportation as the agency responsible for pipeline safely and drug testing for gas operation personnel. The State Fire Marshall periodically inspects the operating and safely procedures of both investor-owned and publicly-owned gas utility. As well, physical plant inspections are made to ensure the property is properly used and maintained.

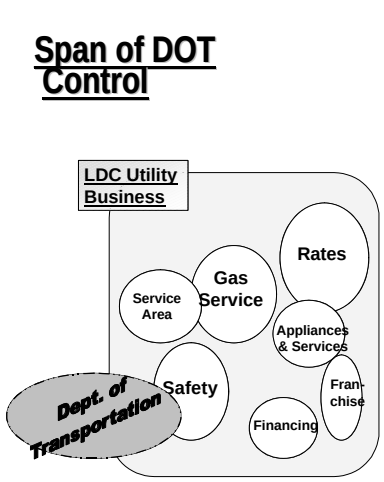


Figure 4 The Nebraska Pipeline Safety Regulation Rests With the State Fire Marshall

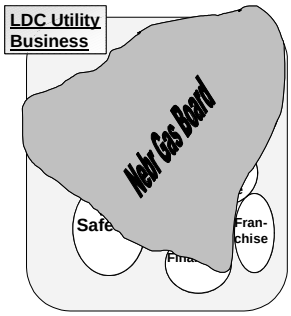
Lying atop the municipal regulatory authority is the power of the Nebraska Courts to review municipal rate decisions. The courts review the municipal rate decisions using a substantive,

not procedural, standard for lawfulness. Municipal rate decisions face a stricter test by the courts than would a regulatory commission. The courts begin again, hearing new evidence on the adequacy of the rates. The municipality's decision faces a *de novo* review, where the court holds an entirely new hearing, takes new evidence and reaches new conclusions with regard to facts. A regulatory commission is permitted, with its presumption of being an expert body, to rely upon the record and evidence put before it. The court will judge a commission whether procedurally the record and evidence is sufficient without hearing further evidence. The Nebraska court, based upon the evidence placed before it, not the evidence placed before the area rate proceeding, may consider if the rates ordered by the municipality violate the protection against confiscation of property without due compensation. The court may not set rates, but may require further rate action by the municipality if the rates are ruled unlawful.

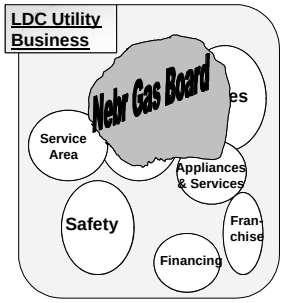
Generally, a strong regulatory commission has broad powers to regulate rates, service and terms and conditions of service provided by the gas utility. This may include rate reductions, as well as rate increases. Further, the commission has powers regulating accounting and financing, record keeping, setting depreciation rates, dealing with consumer complaints, resolving territorial disputes, monitoring and overseeing the utility on an ongoing basis, formally investigating activities, and to enforcing its orders on the gas utility.

The following table displays graphically the range of regulatory authority distinguishing a strong utility commission from a weak utility commission. Nebraska's municipal regulation has more limited authority than even a weak utility commission.

A Strong Utility Commission



A Weak Utility Commission



The following table shows what few powers typically associated with gas utility regulation are exercised under the Nebraska Municipal Natural Gas Regulatory Act.

REGULATORY OVERSIGHT IN NEBRASKA

✓ **Little** ✓✓ **Weak** ✓✓✓ **Strong**

Regulatory Function	Municipal Regulatory Oversight	Other Nebraska Agency
• **Municipal Rate Regulation**		
o **Covers Distribution Costs Like Pipe, Meter Reading and Billing**	✓✓	
o **Covers Gas Commodity Costs**		
• **Service Area Disputes**		✓
• **Affiliate Transactions, Sales and Services**	✓	
• **LDC Appliance and Service Businesses**	✓	
• **Eminent Domain**		✓✓✓
• **Pipeline Safety**		✓✓✓
• **Service Quality**		

Regulatory Function *(continued)*	**Municipal Regulatory Oversight**	**Other Nebraska Agency**
• **Accounting**		
o **System of Accounts**	✓ **(by Statute)**	
o **Regulatory Audits**		
• **Financial Dealing**		
• **Continuous Surveillance of Utility Practices and Compliance**		
• **Consumer Choice**	✓	
o **Competing Supplier Oversight**		
o **Fair Dealing**		

Rate Areas

The Nebraska Municipal Gas Regulation Act further permits each utilities service territory to be divided up into separate rate making areas. This division is determined solely by the utility, subject to rejection by each municipality. If rejected, the assignment goes to the court for a finding if the assignment is reasonable. The court may only affirm the rejection, but may not draw new boundaries by its own actions. This leaves the utility in charge of revising the rate area. The result has been a balkanization of ratemaking authority with larger cities, with assignable paid staff resources, segregated from small rural town and villages, and with little paid staff. In the sixteen different rate areas, groups of municipal employees have to be

gathered to carry out the rate proceeding. An apt analogy of local municipal officials and employees would be to a pickup basketball team, whose members work day jobs, go to the gym in the evenings, and play ball on recreation league games. In an area rate proceeding this team of local volunteers are up against the big city pro-team—the well paid, well prepared corporate gas utility attorneys, employees and consultants. Further, seventy percent of the cities and towns in each rate area must organize at the beginning of each area rate proceeding to proceed jointly. The time and effort to organize and carry out the area rate proceeding, and bring the rate ordinances to finality in each town and village, is extensive. This time and effort from either paid city employees or volunteers is extensive, taking these people away from other city tasks or their jobs and businesses. These costs are not covered by the Loan Fund, but by the municipalities or individuals. Plus once organized, the cities and to towns, must work together, an end reportedly difficult to accomplish among disparate municipal schedules and interests. This adds greatly to the unmeasured "people cost" associated with the area rate proceeding process. Finally, several of the rate areas are geographically large, encompassing many towns and villages, making coordination and organization doubly difficult.

The first panel in the following shows KN Energy with eleven rates areas, and the third panel shows Peoples Natural Gas Co. with three rate areas. The two other investor-owned utilities, MidAmerican Energy Co and NorthWestern Public Service Co., are very localized and operate one rate area each. The large number of rate areas, not only is administratively and organizationally burdensome, but permits disparate rates between rate areas. Though some rate differences might be justified by costs, the municipal regulatory

scheme allows no review to determine if rate differences between rate areas reflect undue and unreasonable rate discrimination. This is one important failure of the area rate concept. No one determines if the Scottsbluff rate is fair compared to the Alliance, the Chadron, the Imperial, the Cozad or the Randolph rates, since they are all in different KN Energy rate area. Or if the People's rate in Norfolk and Pawnee City is fair compared with that in Lincoln or La Vista and Bellevue for again each lies in different rate areas. And fair does not mean equal, but also unequal if the costs differ between customer classes.

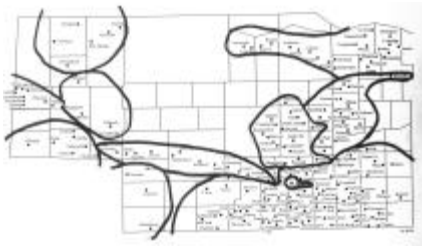


Figure 5
KN Energy
Rate Areas (11)

Figure 6
MidAmerican Energy
Rate Area (1)

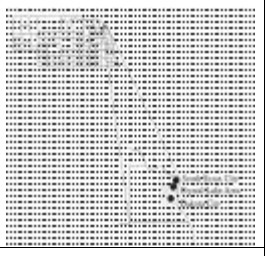


Figure 7
Peoples Natural Gas Co. (3)

Figure 8
NorthWestern Public Service Co.
Rate Area (1)

Source: Nebraska Energy Office, "Public Officials Handbook on Natural Gas Regulation"

Unregulated Customer Groups

Another regulatory void are the rates charged customers outside of municipal areas. These rates appear to be usually established informally and equal to those in adjacent municipalities. This is only a utility practice, and is not required. When utility rates increases have been filed, utilities have raised rural rates during the period while the area rate

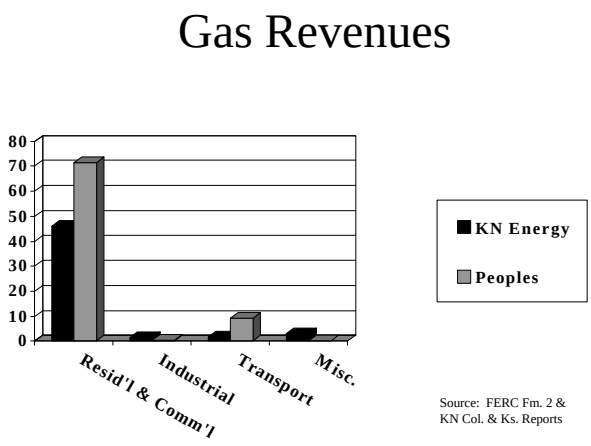


Figure 9

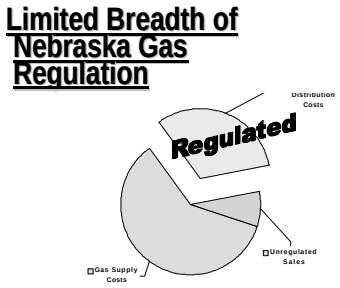
proceeding is in progress.

These rural customers simply are outside the protection of any regulatory authority. A much larger block of customers outside the regulatory scheme are the industrial customers. The Municipal Natural Gas Regulatory Act excludes rates of industrial customers from municipal

regulation. The transportation revenues in the above chart understate the importance of these customers, because the gas costs are paid directly to the gas marketers, bypassing the utility, while the gas costs are included in residential and commercial revenues.

Gas Supply Costs

A third area where natural gas rate regulation is circumscribed comes from the exclusion of natural gas supply costs from rate regulation by municipal regulators. Though the purchased gas cost recovery clause is filed with the cities, municipal consultants have not raised the costs underlying these amounts, plus the utilities have claimed municipal oversight of gas costs is not allowed. The chart to the left shows EFR Ltd.'s estimate of the amount of costs subject to Nebraska's municipal regulation oversight.



This matter is a part of the P-0802 controversy now before the Nebraska courts. Originally, this KN Energy's take-or-pay surcharge was included in the purchased gas cost rate. One question is whether KN Energy ever brought this cost before the municipal regulatory authorities and received any approval to charge customers for this as a part of gas costs. When KN Energy subsequently moved the surcharge into the delivery charge, the controversy now in court arose.

Though Federal preemption removes some discretion regarding the regulation of gas costs for both municipal or state regulatory bodies, other important questions need to be answered;

e. g. Are gas supply costs being properly being allocated to Nebraska regulated customers? That is the very question being raised with regard to Peoples in newspaper articles appearing in mid-December.[3] This is leading several states to do discovery in order to investigate the issue. This omission of gas costs from regulatory oversight severely circumscribes the actual oversight Nebraska municipalities exercise.

Lack of Continuing Surveillance

Another important regulatory limitation in Nebraska is the regulatory span of attention. The regulatory oversight is limited to the periods when utility rate cases are under review by the municipalities and the consultant is under contract. Between rate cases, regulatory attention is sporadic and often non-existent. The Act even limits the frequency when the municipalities can initiate rate actions, a limitation the utilities seeking rate increase does not share.

Municipal Regulatory Effectiveness

The Municipal Natural Gas Regulatory Act's effectiveness was examined by EFR Ltd. Many city officials, city employees and city attorneys were contacted via telephone, surveys and in person at meetings. Making a toll-free number available and sending out surveys to cities statewide facilitated responses.

The goal was to determine what the actual participants in area rate proceedings had observed. The responses gathered were from individuals working in the regulatory trenches at many cities. The following table summarizes the results of these responses.

[3] "UtilitiCorp Accused of Making Improper Profits on Resale of Gas," Omaha World-Herald Online Edition. December 9, 2000, WWW.OMAHA.COM

- Lack of Expertise
  - Issues too complex for lay volunteers to handle
    - Face complicated issues too difficult for the cities
    - Hard even to follow Cities' consultant
  - Infrequent cases
    - City officials turnover causes inexperience
    - City officials can not gain and keep expertise
    - Cases lack consistency
- Lack of Time
  - Volunteers do not have time to participate
  - Tight procedural schedules limits examination
  - Utility filings and information
    - Too much paper to examine
    - Unresponsiveness to information requests
- Lack of Organization
  - Hard to gather 70% of cities to apply for loan funds
  - Hard to coordinate the large number of towns widely spread over the rate areas
  - Utility strategies weaken the cities cohesion
    - Lobby the city government to favor the utility
    - Settle with cities with the weakest resolve
    - Settle with the largest town or city, leaving the smallest towns alone
  - The Cities have a herd effect, following the consultant or the strong voice at the meeting.

Figure 10 Responses From Municipal Regulators

The responses describing the weak Municipal Natural Gas Regulatory Act have been singularly negative. Below are shown typical responses of municipal regulators involved in area rate proceedings and settlements of rate proceedings during the last decade. No responses were received that unconditionally favored the existing area ratemaking procedure. The larger cities and towns response differed from those of the smaller towns and villages. First, the larger towns or cities do not use the area rate proceedings. They have been circumventing it. Instead, the larger cities and towns negotiate directly with the gas utilities. In the process, the larger municipalities have reviewed a quid pro quo. In exchange for settling the rates, the city(s) gets financial incentives. In these settlements, the cities have received economic development contributions or other revenues. Considering that these payments come either at the expense of the municipality's own citizens or ratepayers in other municipalities, these payments are bad ratemaking practice.

The area ratemaking process is left to the smaller towns in rate areas to carry forward, if they will. But at the same time, they are facing pressures to accept a similar conclusion to that already negotiated by the larger cities but often without the incentives. These small towns are the least able to conduct a thorough ratemaking investigation and hearing. After one or two

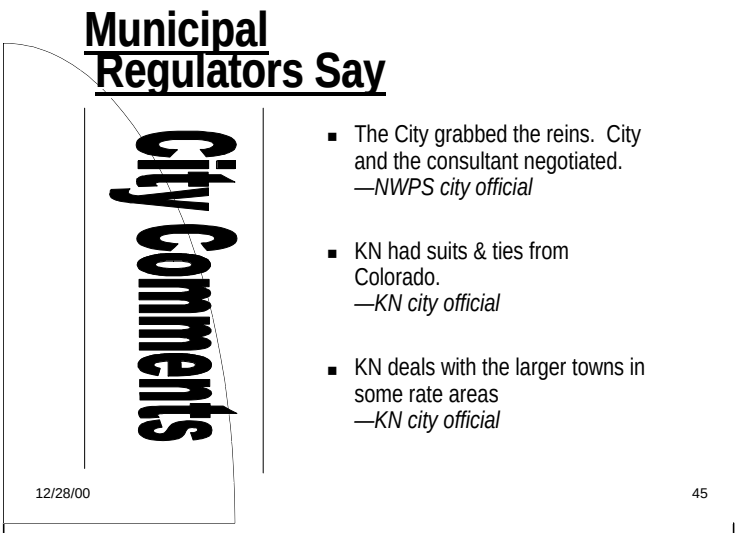
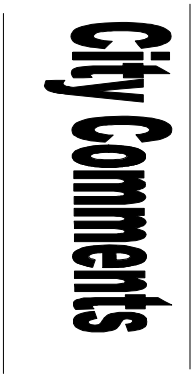


Figure 11

The first panel shows a cross-section of opinions about how the area rate proceedings was carried out—some by negotiation; others by separate deal making.

attempts to carry out a successful rate proceeding, the cities' officials have become frustrated, and either choose not to be involved in new area rate proceedings, or take a back seat. Little in the way of concessions by the utility will prompt city officials to settle the area rate proceeding. The completeness and thoroughness of the investigation suffers, leading to more costly rates for customers.

Municipal Regulators Say



- Did not get involved. Did not feel it was worth the money. …. Need to be a rocket scientist to read all the … nat. gas companies hand out.
  —postmarked Republican City

- The Council backed KN Energy whose representative kept us informed.
  —postmarked North Platte

Figure 12

Some towns stayed out of the area rate making processes while others accepted the utility rates.

Municipal Regulators Say

City Comments

- The Council did not follow the issue. Accepted whatever was suggested without question.
  —Peoples city official
- City Councils are no match for the legal and technical expertise of the IOUs. …. will most often accept a rate increase or the like, without making the IOU truly justify the rates, etc.
  —KN city official

Figure 14

The issues involved in the area rate proceeding overwhelmed some cities.

Municipal Regulators Say

City Comments

- Act poorly written. [It] frustrates the process.
  —Peoples city official
- Hard to keep cities informed & working together.
  —KN city official
- Peoples bought its competitor. Choice in name only.
  —Peoples city official
- Many citizens...need the municipal government or rate area to represent their interests.
  —Peoples city official

Figure 13 Many conflicts hindered the goal, protecting the consumer.

Municipal Regulators Say

City Comments

- Area Rate procedures are unwieldy
  —KN city official
- It is very difficult to get information from the gas company.
  —Peoples city official
- The Municipal Loan Fund seems to work well.
  —Peoples city official
- PGA process not included in rate making
  --Peoples city official

Figure 15

The unwieldy area rate proceeding did not address gas costs. Information was difficult to get from the utilities. The Municipal Loan Fund helped the cities by working well.

Municipal Regulators Say

City Comments

- It should be about changing regulatory policy from single municipalities who have to band together to ineffectively try to provide regulation.
  —postmarked Gothenburg

- We never dealt with the Municipal Loan Fund.
  —Peoples city official

Figure 16

Organizing many municipalities for across an area rate was hard. Some area proceedings were conducted without use of the municipal loan fund.

Municipal Regulators Say

City Comments

- Some towns settled; the holdouts got higher rates.
  —KN city official
- Largest users outside the city. Where do they go when they have a problem.
  —Peoples city official
- Leave regulation alone.
  —MidAm city official

Figure 17

Some towns settled on their rates with the utility, leaving others to fend for them selves. Ratepayers outside city limits have no rate protection. Some larger towns wanted to continue their negotiation posture without interference.

Municipal Regulators Say

City Comments

- Did not bid for consultant.
  —KN city official
- Consultant gave nice reports, that were not understandable
  —KN city official

Figure 18

Bids were not taken for the cities in several cases, or lower qualified bidders rejected. The consultant's reports did not suit the needs of some municipalities.

Municipal Regulators Say

City Comments

- Even if the city is doing the job, it needs tools and information to do the job.
  —KN city official
- Consultant gave nice reports, that were not understandable
  —KN city official
- The consultant couldn't counter the deluge of papers presented by KNE
  —KN city official

Figure 19

Hiring outside consultants to report to municipal councils through the area rate proceedings was not enough regulatory support.

Municipal Regulators Say

City Comments

- Negotiations were made unnecessarily lengthy and difficult as city representatives interrupted the consultant to express their perceived expertise to the gas company representatives.
  — *Peoples city official*

- Rate area 8 is too large to organize.
  —KN city official

Figure 20

The area rate proceedings could be unwieldy. The municipalities were hard to bring together. Negotiations were difficult when the cities disagreed among themselves.

Municipal Regulators Say

Conclusion

- Larger towns bypass area rate proceedings and seek to negotiate with utilities
- Smaller towns see area rate proceedings as frustrated and ineffective

Figure 21

Two conclusions appear from the opinions of municipal officials and employees who have worked in the regulatory trenches during area rate proceedings. Neither the larger nor the smaller cities or towns are able to use the area rate proceedings effectively. The larger cities and towns work around the area rate proceedings by negotiating a resolution. The smaller towns and villages are not able to get satisfactory rates resolved by the area rate proceedings.

Regulatory Costs

Nebraska's two main investor-owned gas utilities spent $412,100 in 1999 on municipal ratemaking in Nebraska. The year 1999 was not a very active year for rate proceedings either. This is an incomplete estimate because it does not include ongoing municipal liaison and lobbying expenses indirectly linked to municipal regulation. It also does not include any costs directly paid by the municipalities involved, or the time municipal officials or employees devoted to regulatory work. Nor are the costs of the financial incentives paid to municipalities as a quid pro quo for settling rates cases included. No significant savings is apparent under municipal ratemaking, probably because of its redundancy.

Table 1: **Nebraska Regulatory Costs By Nebraska Gas Utilities**

	1999 Regulatory Commission Expenses
KN Energy	$330,000
Peoples Gas Co.	$82,100
Total	**$412,100**

Source: KN Energy and Peoples Natural Gas Co. FERC Form

Rate Making and Other Regulatory Procedures

Local gas delivery companies are considered natural monopolies since it would be uneconomical to serve individual customers with duplicative gas mains. The purpose of public utility regulation is to insure safe and reliable service and to set just and reasonable rates which are fair to both the public utility and ratepayers. The goal of public utility regulation is to insure that utilities, like a business facing competitors, will provide safe and reliable service at a reasonable price. A reasonable price, as in competition, is determined by prices that recover their necessary and reasonable costs and earn a fair rate of return for capital.

Cost of Service Standard

Whether investor-owned or publicly-owned, gas utilities use the cost of service approach to setting rates. The municipalities, whether operating as regulators or through municipal utility oversight boards, adhere to the standard that gas rates should be based on costs. The difficulty comes, not from the principle, but from the interpretation of what costs and how much of the various costs should be included in the revenue requirement determination.

Section 4612 and Costs

Section 4612 of the Municipal Natural Gas Regulation Act provides the following guidelines for determining public utility rates based on costs. The Municipal Natural

Gas Regulation Act adopts the cost basis for establishing gas utility rates. The basis for cost of service set forth in the act can be simply put forward in some abbreviated formulas:

Revenues from Customers	Costs of the Gas Company
Revenue Requirement equals Operating Expenses + Depreciation Expenses + Taxes + Return	

The Return, in turn, is based on another formulas:

> Return to Stockholder and Debtors = Rate of Return times Rate Base, where Rate Base = Original Cost of Used and Useful Property less Accumulated Depreciation

Of course, the actual implementation involved more than simple formulas, but these basic formulas are what underlie the determination of utility revenue requirements.

The Act allows:

- The municipality, in the exercise of its power under the Municipal Natural Gas Regulation Act to determine just and reasonable rates for public utilities. The municipality is:
  - To give due consideration to the public need for adequate, efficient, and reasonable natural gas service
  - To the need of the utility for revenue sufficient to enable it to meet the cost of furnishing service
    - Cost of service shall include operating expenses and a

fair and reasonable return on rate base, less appropriate credits.

- Operating expenses shall consist of expenses prudently incurred to provide natural gas service including a reasonable allocation of common expenses.
- Including adequate provisions for depreciation of its utility property used and useful in rendering service to the public
- To earn a fair and reasonable return upon the investment in such property.
    - Representative of the utility's weighted average cost of capital including, but not limited to:
        - Long-term debt,
        - Preferred stock, and
        - Common equity capital.
- The rate base of the utility shall consist of:
    - The utility's property, used and useful in providing utility service, including the applicable investment in utility plant

- Less accumulated depreciation and amortization,
- Allowance for working capital, such other items as may be reasonably included, and
- Reasonable allocations of common property
- Less such investment as may be reasonably attributed to other than investor-supplied capital unless law otherwise prohibits such deduction.

- In determining the cost of service, the municipality shall give effect to all costs and allocations upstream of the town border station of the utility as reflected in the rate schedules approved by the Federal Energy Regulatory Commission or its successor.

Section 4621 and Accounting

One requirement for effective regulation is accurate public utility accounting records and financial reports. Section 4621 of the Municipal Natural Gas Regulation Act provides the following concerning public utility accounting records:

- Every utility shall be required to keep and render its books, accounts, papers, and records accurately and truthfully in accordance with the system of accounts prescribed by the Federal Energy Regulatory

Commission or its successor.

- All accounting information provided by utilities to municipalities shall be presented in accordance with the system of accounts prescribed by the Federal Energy Regulatory Commission.

The Federal Energy Regulatory Commission's prescribed a system of accounts, entitled "Uniform System of Accounts" ("USOA"), provides instructions, definitions and a chart of accounts to be used for accounting and financial reporting purposes. Regulatory Commissions typically have the power to inspect, analyze and audit the utilities book of accounts and supporting records. The Nebraska municipalities do not have any means to do such reviews and audits.

In addition, the FERC requires the filing of annual reports (i.e., FERC Form No. 2) by natural gas companies subject to the provisions of the Natural Gas Act. While the FERC annual reports are helpful, most states require the filing of additional information, which provides state specific information. Only the City of Lincoln, though its newly renegotiated franchise agreement, receives even a superficial annual report from Peoples Natural Gas Company. The annual reports required in Minnesota, Iowa and Colorado, for example, are very detailed and provide state jurisdictional information comparable to the annual report information provided in the FERC Form No. 2.

The Nebraska gas utilities do not file annual reports providing state specific information. This makes it virtually impossible to compare individual gas utility's Nebraska financial results, costs and sales with the results of other states, or even to compare the results

of the four investor-owned gas utility operations within Nebraska. Only the City of Lincoln receives any annual report, albeit a rudimentary one of little use. This requirement was included in the recently renewed franchise requirement between the City of Lincoln and Peoples Natural Gas Company. The experience gained while preparing this report shows that Nebraska records are only sparsely kept or made available in Nebraska, and even then only under extraordinarily far reaching claims of confidentially. Reporting of the information requested here in other states is routinely public information. Even within Nebraska, one utility might claim confidentially while another openly provided the response.

It is important that customers know what their utility rates are paying for. This leads to public trust of the utility regulatory system. Excessive secrecy leads to suspicions, founded and unfounded, that the utility rates are unfair, and even worse that the regulator is part of the problem. The Nebraska regulatory system appears to operate under a guideline that the utility need only claim confidentially, without sufficient enforcement of the need to ensure public confidence by fully informing the customers what the rates they pay for gas service buy.

Section 4612 and Affiliate Transaction

Section 4612 (5) of the Municipal Natural Gas Regulation Act states the following:

> Operating costs shall consist of expenses prudently incurred to provide natural gas service including a reasonable allocation of common expenses.

The reasonable allocation of common expenses has become an increasingly complex

issue due to the increase in recent years of affiliated transactions between regulated and non-regulated companies under common ownership and management.

Affiliated transactions are transactions for goods or services between two companies, which share common ownership through a holding company structure. A holding company is a form of business organization consisting of a parent company and its subsidiaries. The parent company exercises control over its subsidiaries through the ownership of the stock of the subsidiaries. This control is enhanced through the appointment of common directors and officers throughout the corporation and the creation of service agreements, operating agreements and other arrangements which bind the separate subsidiaries to the overall corporate goals (e.g., profit maximization). Since affiliated companies share common ownership, these transactions lack arm's length bargaining and have been contested in public utility rate proceedings for decades.

Affiliate transactions and potential for cross-subsidization are a concern now more than ever before. The gas industry is rapidly changing as gas utilities unbundle their services and expand into non-regulated ventures using utility expertise and shared costs. Gas companies have been forming new subsidiaries that engage in competitive gas marketing, power generation, contracting and a variety of other services. These companies have also been expanding into other areas of business including telecommunications, real estate and other ventures. Utilities have also expanded into international ventures, which involve added risks and complexities.

For example, Peoples Natural Gas Co. is a division of UtiliCorp United Inc. ("UtiliCorp"). UtiliCorp describes itself as a multinational energy solutions provider. UtiliCorp's operations include domestic and international network of electric and gas generation, distribution and transmission businesses, as well as appliance repair and servicing businesses. In addition, UtiliCorp is actively involved in domestic and international energy marketing and trading businesses; natural gas gathering, processing and transportation businesses; and independent power projects. UtiliCorp's Aquila energy-marketing unit, recently spun off in an IPO, is one of the nation's largest power marketers. UtiliCorp also has ownership in Quanta Services, Inc., which is a provider of specialized construction services to electric utilities, telecommunications and cable television companies and governmental entities. UtiliCorp's international operations include the United Kingdom, Spain, Germany, Norway, Australia, New Zealand and Canada.[1]

KN Energy is a division of Kinder Morgan, Inc. ("Kinder Morgan"). In 1999, Kinder Morgan sold its interstate pipeline to Kinder Morgan Energy Partners ("KMP"), receiving $400 million in cash and 9.8 million limited partnership units in exchange. As a limited partner of Kinder Morgan Energy Partners, Kinder Morgan will receive about 40% of the earnings of KMP and about 60% of its cash distributions. Kinder Morgan bills KN Energy for labor, non-labor and other costs incurred on behalf of KN Energy. In

[1] UtiliCorp United Inc.'s 1999 Securities and Exchange Commission Form 10-K and Value Line.

addition, KN Energy receives charges from other Kinder Morgan affiliated companies including Rocky Mountain Natural Gas Company, Northern Gas Company, Kinder Morgan Interstate Gas Transmission Company, and KN Gas Supply Services, Inc. In 1999, KN Energy's costs from these other affiliated companies totaled $52.099 million.[2]

NorthWestern Public Service is a division of NorthWestern Corporation. NorthWestern Pubic Service provides electric and natural gas services throughout the MidWest. NorthWestern Corporation's other activities include Expanets, Inc., which provides integrated communication and data solutions and network services in 32 states; CornerStone Propane Partners, which a retail propane distributor in 34 states; Blue Dot Services, Inc., which provides air conditioning, heating, plumbing and related services in 23 states; and NorthWestern Growth Corporation, which is involved in development and investment operations.

Berkshire Hathaway wholly owns MidAmerican Energy Co. now. MidAmerican Energy has been built up from numerous mergers of formerly independent utilities in Iowa and Illinois, and world-wide, over the last twenty-years. MidAmerican Energy sells both electricity and gas. MidAmerican Energy recently announced an example of affiliate marketing. It is marketing a utility payment assurance plan, which would pay the customers utility bills after six months of unemployment. This insurance plan, being sold by MidAmerican, is underwritten by another Berkshire Hathaway company that

[2] KN Energy's 1999 Federal Energy Regulatory Commission Annual Report (FERC Form No. 2) and Value Line.

markets insurance.

While the utility divestiture into multiple domestic and international ventures has aided corporations in the pursuit of profit maximization, this divestiture has introduced multiple complexities to the allocation of costs used in the determination of rates to charge captive utility gas customers. Success in the competitive market is often directly related to the price charged for those competitive services. When regulated and non-regulated, competitive and monopoly services are provided under the same corporate umbrella, there is added pressure to shift costs to the non-competitive operations in order to maximize overall corporate profits. This can lead to captive gas utility ratepayers subsidizing competitive services as corporations expand into non-regulated, competitive markets.

The cross-subsidization of non-utility, competitive ventures through charges to captive gas utility ratepayers should be a major concern of regulators. These problems will continue as corporations divest into risky non-utility, non-regulated domestic and international ventures in the pursuit of profit maximization.

Depreciation Rates

Depreciation is another major consideration and potential problem area in public utility regulation. The FERC's definition for depreciation is set forth in its Uniform System of Accounts as follows:

> "Depreciation," as applied to depreciable gas plant, means the loss in service

> value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of gas plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities, and, in the case of natural gas companies, the exhaustion of natural resources.

Section 4612 (1) of the Municipal Natural Gas Regulation Act provides that utilities are entitled to:

> Revenue sufficient to enable it to meet the cost of furnishing the service, including adequate provisions for depreciation of its utility property used and useful in rendering service to the public, and to earn a fair and reasonable return upon the investment in such property.

A depreciation analysis requires the examination of several years of data related to average service lives, retirements, salvage and cost of removal. Depreciation studies should be performed periodically (e.g., every 5 years) to insure that depreciation rates charged are appropriate.

The Municipal Natural Gas Regulation Act does not require Nebraska gas utilities to perform periodic depreciation studies. In addition, Section 4614 (1) of the Municipal Natural Gas Regulation Act provides that the utility shall not be required to perform analyses or analytical studies of information in responding to requests for supplemental information in a general rate review. This means that if a gas utility does not voluntarily provide a depreciation rate study, the utility cannot be asked to perform such an analysis.

Also, Section 4614 (1) of the Municipal Natural Gas Regulation Act provides that

historical data more than one calendar year older than the date of the last general rate filing shall be presumed to be irrelevant except to the extent that such data was utilized by the utility in the rate filing. This means that if a consultant wanted to perform a depreciation study, the information which could be gathered would be limited to one calendar year prior to the date of the last general rate filing.

Regulatory Limitations

The following are some of the limitations on local municipality regulators that no doubt restrict gas utility regulation in Nebraska:

- There are little, or no, penalties or other provisions in the law to force gas utilities to comply with the Regulatory Statute, or municipal ordinances.
- Under Section 4618 (1) and (2) of the Municipal Natural Gas Regulation Act, a municipality can initiate a proceeding for review and adjustment rates only once every 36 months. In addition, no municipality shall be entitled to any filing fees or assessments against the utility when the municipality initiates a rate adjustment nor shall the municipality receive a loan under section 17 of this act for such purposes.
- Section 4614 (1) of the Municipal Natural Gas Regulation Act provides that the utility shall not be required to perform analyses or analytical studies of information in responding to requests for supplemental

information in a general rate review.

- Section 4614 (1) of the Municipal Natural Gas Regulation Act provides that historical data more than one calendar year older than the date of the last general rate filing shall be presumed to be irrelevant except to the extent that such data was utilized by the utility in the rate filing.
- Section 4609 (2) of the Municipal Natural Gas Regulation Act provides that the utility may initiate judicial review of a cities' gas supply-cost-adjustment order, and if it does so, the order of the municipality shall not take effect during the pendency of such review. The utility can file new evidence in support of its case in the judicial review process.
- Section 4616 (7) of the Municipal Natural Gas Regulation Act provides that the utility may initiate judicial review of a cities' general rate change order. The utility can file new evidence in support of its case in the judicial review process.

Customer Cost of Service and Rate Design Studies

After the revenue requirement is established, studies should be prepared periodically to determine the distribution of the revenue requirement among the different groups of customers. These studies take into account the usage characteristics of the different customer groups to determine how much cost each customer group in fact causes and ought to pay. This class cost of service studies determine what share of the revenue requirement should be collected from the different classes of customers, e.g. the

residential or commercial customers.

Also, the rate making process should include a rate design phase. This involves determining in what manner individual customers will be billed. The outcome of this phase is to determine such rates as the customer charge and the commodity block(s) charge(s). This phase also is based on the usage pattern of the customers, the costs assigned to that customer, and how the customer's metering will permit the billing to be done. For example, residential metering is much simpler and so is the rate design, than say, a large industrial customer whose metering may be recorded electronically day-by-day, and whose billings and rates are accordingly more complex. KN Energy's rate design has a customer charge and several rate blocks. Peoples Natural Gas Co. rate design is markedly simpler using a customer charge and a minimal number of rate blocks.

Whatever the phase of the regulatory process for setting rates--the revenue requirement determination, the class cost of service assignment, or the rate design phase, a great deal of expertise and specialization is required. It is not surprising that the municipalities in Nebraska were frustrated, or simply worked around the statutory area rate proceeding by substituting negotiations. Without the authority and power to extensively investigate the utility's rate filing, its rates, and terms and conditions of service, there is little the municipal rate consultant can accomplish within the short span allowed for the area rate proceeding to proceed. A quick review by an outside consultant, often facing delays and roadblocks placed by the utility, may be all the

municipals can get. The consultant can do little more than spot check the revenue requirement, the class cost of service assignments, and the rate design filed by the utilities that are filed. The ability to provide an independent thoughtful assessment is beyond the limitations of the Municipal Natural Gas Regulation Act. Any ongoing continuous surveillance to insure rates stay in line with cost and changing gas markets is impossible under the current statute. In fact, the statute does not even give the municipality any more than a copy of the utility's rates to be filed for information only. The municipalities have no official means by which they can even address customer complaints. Another important area, the utility's terms and conditions of service, is not even considered in the statute.

The task of overseeing annual reports and accounting standards routinely is also outside the reach of the municipal regulatory system. In fact, it might literally be impossible to compile reports giving specific information on sales, costs and other information for every municipality, or even in every rate area. Such a task would be better done on a statewide basis. Even if such reports or accounting oversight were undertaken, the municipalities do not have the resources to undertake this collection, review and resulting oversight of the gas utilities.

CHAPTER 6

Federal Regulation

The Federal Energy Regulatory Commission regulates interstate pipeline transportation of natural gas

The Federal Energy Regulatory Commission oversees the United States' natural gas pipeline industry. The primary laws authorizing the Federal Energy Regulatory Commission (FERC) are the Natural Gas Act (NGA) of 1938, the Natural Gas Policy Act (NGPA) of 1978, the Outer Continental Shelf Lands Act (OCSLA), the Natural Gas Wellhead Decontrol Act (NGWDA) of 1989, and the Energy Policy Act (EPAct) of 1992. Numerous court decisions further refined the expanse of the authority assigned under these acts.

Domestic gas service in the Midwest was originally supplied using gas manufactured from coal. By the 1920s, natural gas was abundantly available as a byproduct of oil production. Improvements in welding techniques and other technologies permitted construction of long-haul pipelines to move that gas from producing regions, primarily in the Southwest, to large consumer markets in the Northeast and Midwest. By the 1950s, natural gas had virtually displaced manufactured gas from Nebraska markets.

Construction of interstate pipelines led to the adoption in 1938 of the Natural Gas Act (NGA). The NGA established federal jurisdiction over the construction and operation of these pipelines, interstate transmission of natural gas, and sales of natural gas for resale.

Responsibility for federal gas regulation was given to the Federal Power Commission (FPC), which in 1977 became the Federal Energy Regulatory Commission (FERC). The FPC organized its natural gas work into two major sectors. Certificate regulation dealt with construction, operation, and scope of a pipeline's service. Rate regulation initially required filed tariffs containing the rates, charges, and terms for a pipeline's sales of wholesale gas and for its transmission services.

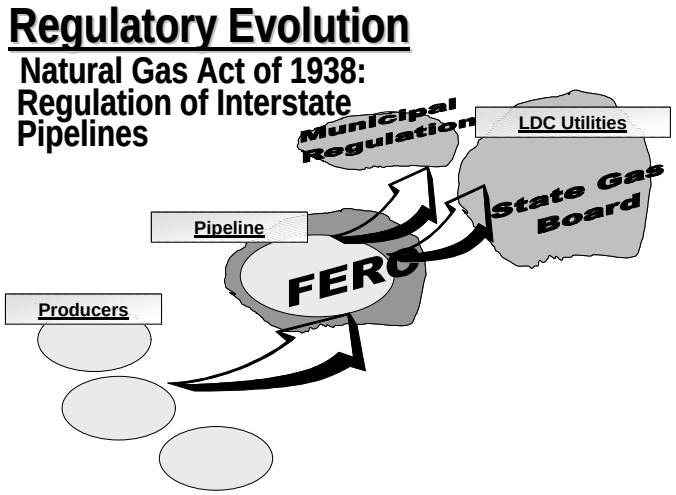


Figure 1

Because the NGA only covered interstate operations, parallel intrastate markets developed in producing states. In a 1954 decision, *Phillips Petroleum Co. v. Wisconsin, 347 U.S. 67 (1954)*, the United States Supreme Court ruled that producers of natural gas were also

subject to the terms of the NGA. Certificate and rate regulation, intended to benefit consumers, gave producers reason to direct new gas supplied to intrastate markets. Because of inadequate commitment of new gas to interstate markets with continued low regulated prices to interstate consumers, shortages of gas supplies became evident in interstate markets in the 1970s, while the less-regulated intrastate markets continued to have adequate gas supplies.

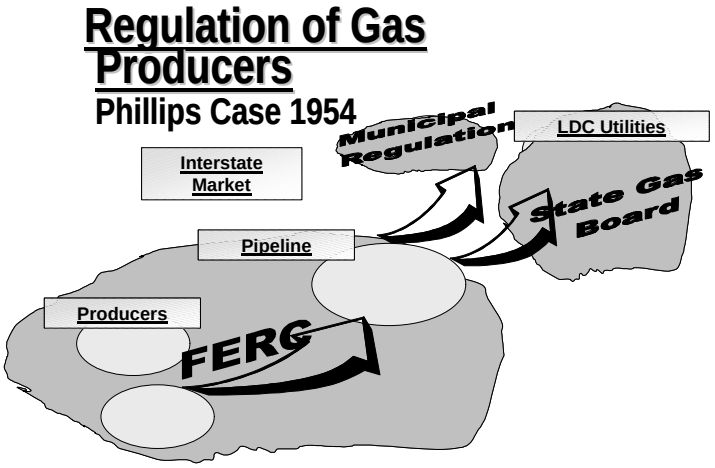


Figure 2

The Natural Gas Policy Act of 1978 (NGPA) attempted to solve these disparities between markets. The NGPA included three major strategies. First, it allowed gas to be exchanged between the intrastate and interstate markets. Second, it set a path to eventual deregulation of commodity pricing, through escalating price ceilings. Third, it provided for continued rate and certificate regulation of sales and transportation service by interstate pipelines. Rate regulation included both a triennial review of a pipeline's

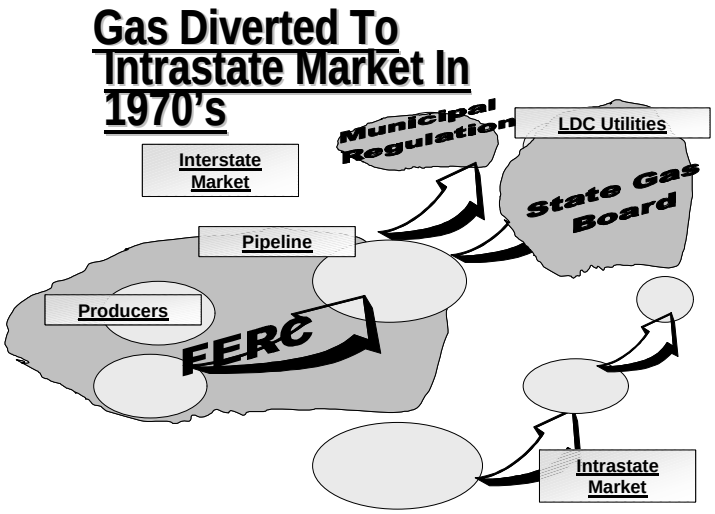


Figure 3

basic service rates and continuous monitoring of its automatic purchased gas adjustment (PGA) rate.

The NGPA, by stimulating the amount of gas committed to consumer markets, led to the oversupply of the 1980s. The oversupply, initially called a "gas bubble," stretched into a

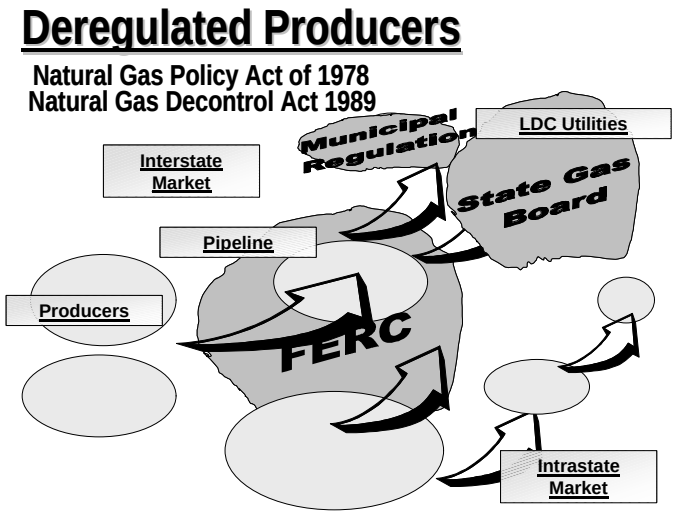


Figure 4

"gas sausage" of several years before supply and demand factors evened off. During the extended "gas bubble," increased supplies of gas were available at less than regulated prices, leading customers to demand unbundling of pipeline services: i.e. customers insisted on purchasing transportation service from pipelines without purchasing the gas itself from the pipeline.

Unbundled retail services also became available in many states. Unbundling in the wholesale natural gas market took the form of FERC Orders 436 and 636, adopted in the mid 1980s. Pipelines were required to offer transportation service on terms equivalent to the service that was included in their sales service. This transportation service opened opportunities for the growth of gas marketers and other third-party suppliers of gas. By the late 1980s, LDC's had become active buyers of third party gas;

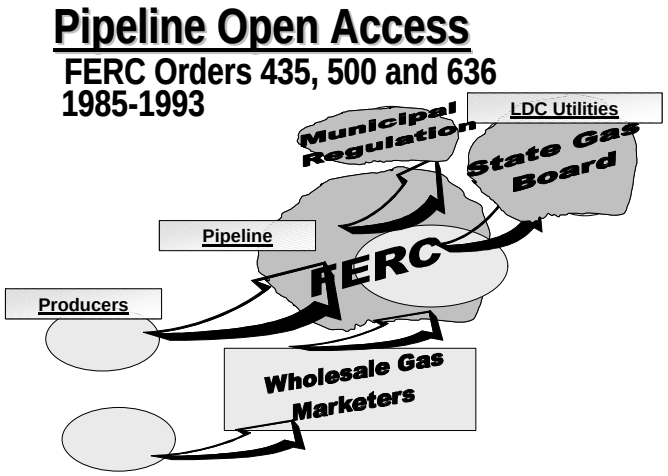


Figure 5

with savings to their system supply cost. Some large industrial customers also found it possible to take advantage of competitive gas supplies.

Pipeline transportation service under the FERC rules could only reach to the "city gate." A city gate (sometimes called a town border station) is one or more locations where the pipeline delivers gas to an LDC. From that point to the end-user, the LDC subject to state or local control provides gas service to the retail customer. When an active market in gas supplies emerged, many industrial customers sought direct access to those competitive supplies. Their demands led most states and most LDC's to offer unbundled transportation service. The LDC transportation service could be combined with transportation service on interstates pipelines to allow customers to access gas over wide geographic markets. Similarly, gas producers and marketers could reach a much broader range of customers. State and LDC transportation programs began in 1984, and reached most retail markets by the early 1990s.

The deregulation of gas supply markets was completed by the Natural Gas Wellhead Decontrol Act, enacted by Congress in 1989 and fully effective in 1993. About the same time, FERC concluded that the pipelines' dual roles of merchant and transporter created conflicts of interest that could not be reasonably resolved. It found that the burdens of regulating these conflicts and assuring that transport service is available on a non-discriminatory basis are greater than the benefits of maintaining integrated service. Because of these findings, FERC required the pipelines to end their gas supply merchant functions.

With the end of gas sales service, FERC continues to regulate maximum prices of pipeline transportation service. In recognition of the greater competitive forces in

today's markets, it allows negotiation of lower prices. FERC also regulates many of pipelines' commercial practices to assure fairness and competitive neutrality. When customers renew their contract rights to pipeline capacity, they enjoy priority over other prospective customers only if they pay maximum regulated rates. FERC also continues its certificate regulation of pipeline construction, maintenance, operation and services.

CHAPTER 7

Local Consumer Choice

Local Consumer Choice Extends Gas Supply Choice
To Residential and Commercial Customers

Framework for Consumer Choice

Historically, the local gas utilities purchased natural gas for residential and other small use customers, and delivered the gas to the customers. The local gas utility passes along the cost of the gas commodity to customers through their monthly bills. Commonly, purchased gas cost recovery rates are used. The utilities do not usually profit from this sale of natural gas itself, but instead earn a return on the property they use to deliver the gas.

Customer choice programs allow customers to shop around for a gas supplier and have the gas delivered to the customer by the local natural gas utility. The safety and integrity of the underground pipes used to deliver the gas remains the responsibility of the local natural gas distribution utility. The natural gas utility is responsible for taking the supplier's gas at the town border station (the city gate) and moving it through its pipes to the customer's service location where the customer can take delivery and make use of the gas. Also, a means is needed by which the marketer and independent gas supplier can move gas through the interstate pipeline. This may require the local distribution gas utility company to surrender sufficient reserved capacity to the supplier to move the gas to the LDC's city gate. Or it may require that the gas supplier reserve capacity for itself on the pipeline.

The following chart shows what Consumer Choice adds to the gas utility sales scheme. A number of marketers-some independent of the gas utility, some affiliated—sell gas to small residential and commercial consumers. Rather than having only one supplier, the customer can select a gas supplier. After an arrangement is made to move the gas through the gas utility's local gas delivery mains, the customer receives gas from its own suppliers.

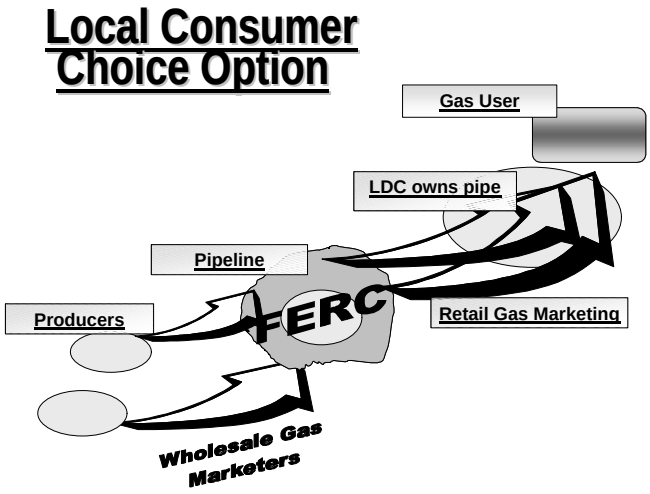


Figure 1

The first customer choice program for residential customers started in Rock Valley, Iowa, in 1995, a town served by Mid-American Energy. A recent survey by the American Gas Association showed that, "Almost 26 million of the nation's 54 million households with natural gas service (nearly 49 percent) can now or will soon be able to buy natural gas from a non-utility supplier." These households are in 23 states and the District of Columbia. Only

one in five of the households with a choice option actually switched suppliers from the natural gas utility.[1]

This compares with large-volume natural gas customers, such as factories and electric-power plants of which 95 percent can select their own natural gas supplier. Also, almost 70 percent of commercial gas customers, such as hospitals and office building, have a choice.

The National Regulatory Research Institute (NRRI), sponsored by the National Association of Regulatory Utility Commissioners, found that pilot consumer choice programs saved small customers only 3%. They found that only 3 million customers have switched from their natural gas utility since the programs began. Residential customers saved only about 7.8%, the report found. NRRI found that the gas saving had not lived up to the expectations for the choice programs.[2] A survey by the GAO of gas utilities that had customer choice programs under way as of July 1998 showed saving of from 1 percent to 15 percent. The GAO found that the savings in many states came from gas suppliers avoiding the payment of the gross receipts taxes paid exclusively by gas utilities in some states.[3] Larger questions about the shifting of tax receipts off governmental units often need to be resolved when consumer choice programs begin. Also use taxes might be avoided it the marketers or gas transporters can arrange to "buy" the gas out of state and only ship the gas into the state for delivery. The gas utility on the other hand may not have this advantage. Just the year before, Kenneth

[1] American Gas Association, "Almost Half of U.S. Households With Natural Gas Can Choose Supplier, American Gas Association Study Finds," published 12/11/00, http://www.aga.org/Newsroom/NewsReleases/3313.html
[2] "How has competition done for gas users," Restructuring TODAY," November 28, 2000.
[3] General Accounting Office, " An Overview and History of Gas Deregulation," April 1999.

Costello, of NRRI, was calling a 10% saving as necessary for a viable consumer choice program.[4]

The recent NRRI survey found some suppliers had taken advantage of customers by selling at a gas rate above that charged by the gas utility. They also found customers had signed fixed cost agreements, only to find rates declining elsewhere. (Of course, in the last year, the opposite would have happened to the pleasure of the customer). Customers also found themselves confronted by pushy marketers and by surprise transaction charges.[5]

[4] Kenneth W. Costello, "Remarks on Gas Customers—Choice Programs," Nov. 9, 1999, http://WWW.NRRI.ORG/
[5] Restructuring TODAY, op. cit.

The following table gives some of the advantages and disadvantages of consumer choice programs.

Consumer Choice Overview

- Pro
  - Provides a choice of suppliers
  - Provides a tailored mix of gas supply and billing
  - Improved competitive incentives
  - Marketing by suppliers
- Con
  - Gas costs savings are small
  - Small no. of gas marketers
  - Confusion of identity between the LDC & gas supplier
  - Increased price discrimination
  - Price fluctuations possible
  - Marketing abuses

Figure 2

In fact, many details of the relationships between the local gas utility and its customers, between the customer and the gas suppliers, and between the local gas utility and the gas suppliers need to be worked out. A number of services need to continue to be regulated under a Consumer Choice program. The delivery system is commonly accepted to be a continuing monopoly that should continue to be regulated. The degree to which the gas supply service should be regulated is controversial. Some level of regulation is commonly viewed as necessary until competition is working fully. This regulatory protection may take the form of continued bundled service or a "standard offer service" that allows customers to retain existing service for a transition period. The local gas distribution company should be required to continue to provide delivery service. It may also be obligated to provide gas supply service for at least during the transition period.

The local gas distribution company plays a critical role in balancing the gas received from

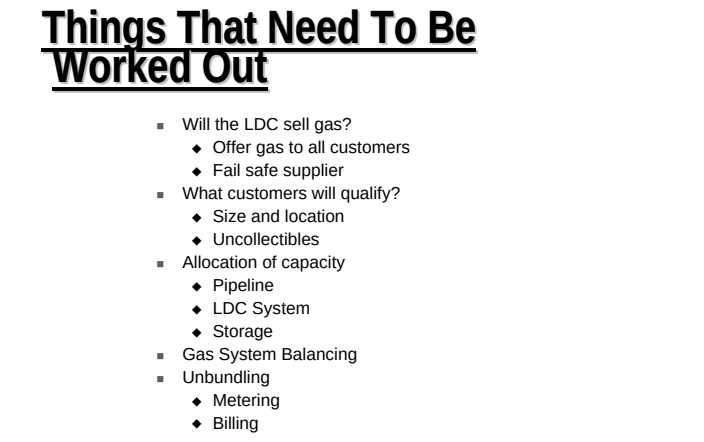


Figure 3

suppliers with the gas used by customers. The LDC needs to balance the gas in-gas out flows of the delivery system. The balancing offsets that occur when user gas volumes are pooled but more than one supplier puts gas into the LDC's mains needs to be considered. This may require adding additional gas, absorbing unneeded gas. The consequences, financial and otherwise, of suppliers failing to balance their deliveries with their customers' usage need to be handled.

The LDC's can continue to read the meters, or a separate billing company can perform the responsibility. In either case, meter reading needs to be an assigned responsibility. The physical connection, disconnection and reconnection of customers will have to remain with the service operator responsible for the safety and responsibility of the gas mains, the LDC. The LDC will have to be ready to connect new customers for marketers, and to disconnect customers not paying their marketer.

Who will bill customers needs to be resolved. Whether the LDC accepts the billing obligation and unbundles its bills, charging the delivery bill separately from the gas supplier's, will need to be determined. Or will the gas supplier bill the customer for the gas delivery charges of the gas distribution company. A mechanism needs to be developed to reconcile the two different billing formats and collection systems. When uncollectible bills occur, the distribution of these lost revenues must be determined. When a customer lodges a complaint, whether the LDC, the gas supplier or both will handle the complaint must be resolved.

When the LDC, or an affiliate, continues to supply gas, the relationship between the LDC and the affiliate need to be defined. Rules are needed to prevent the affiliate from using the LDC

to the advantage of its marketing. Referrals, customer lists, and advertising by the LDC on behalf of its affiliates would be an example where unfair marketing practices could occur.

The gas marketer also must follow fair practices with respect to the retail customers. Representations by telemarketers, their advertising content, their delivery promises, penalties for failing to deliver gas, order verification, the fair use of customer records of the utility and refusal of service to customers are all potential areas where gas marketing practices may be unfair.

Several other matters need resolution. These include use of the utility name and logo, paying for the support of low-income customers and non-paying customers during periods of disconnection moratoriums, the cost of energy efficiency programs, the transition costs, and shifts in taxes paid to political subdivisions. Finally, the important issue of consumer education must be addressed. Customers must be well informed about how the Consumer Choice program works and will affect them. But this information needs to be not only useful, but also neutral.

The regulatory agency can operate as an intermediary, a facilitator and policeman for these arrangements. The regulatory body needs skills beyond those commonly associated with regulation—calculation of the revenue requirement and building rates to collect from customers revenues equal to that revenue requirement. First, the regulatory body has to be willing to accept a competitive segment in the market it is regulating. The state government will have personnel, budget and facilities policies that will affect the regulatory body's staffing, appropriations, and space and equipment available for the expanded regulatory role.

The constitutional and statutory limitations on regulating in a partially competitive market need to be resolved. Undoubtedly the regulatory body will find its orders and policies appealed to the courts, and the larger legal framework of the state, and its courts, must be compatible with the requirement of competition.

Outside the regulatory agency, the utilities, the consumers, other state agencies, state employees, utility employees organizations, the Unicameral and the executive must see the complexities involved in consumer choice. It is not a simple matter of deregulating, because the delivery system remains a monopoly subject to traditional regulation, and the newly competing gas suppliers present a potential area of conflict both with the LDC and the gas customers in which all must be treated fairly. We are all aware of some of the marketing abuses that arise in the telephone market—slamming, cramming, identifying whose equipment is causing service to fail. The shift from the familiar gas supply monopoly to a number of suppliers does not quickly nor easily create a self-regulating competitive market. In between lies the kind of marketplace—something more than a monopoly, but something less than competition. One sees not so much fair-handed competition among equals, but unequal marketers hotly contesting with one another and the LDC or its marketing affiliate for the customers' business. The LDC or its affiliates have noncompetitive market power at one extreme, while at the other extreme some prospective gas suppliers may not be financially or managerially sound. This is the weakly competitive gas supply market the regulatory body has to adapt its regulation to directing. This direction attempts to sustain the best of the competitive forces tending to keep prices at a minimum and supply stable, while delimiting

the market abuses that invite monopoly, unfettered rivalry, unfair marketing and outright consumer fraud, to say nothing of the well intentioned plan that goes awry.

Nebraska Choice Programs

Peoples Natural Gas Co. had a commercial customer choice program some years ago where suppliers other than Peoples could market gas. Because the problems with this program's design and implementation, alternative suppliers dropped out, causing the choice program to atrophy.

KN Energy has a functioning customer choice program in the western two-thirds and south-central Nebraska. In the prior year, 176 Nebraska communities allowed the Choice program. Now 180 permit the Choice program to operate in their community. Under KN Energy's Choice program, the customer selects a supplier for a 12-month period. This selection is made once a year or upon beginning new gas service. Each customer is provided a ballot on which to select a supply. Under the annual selection process, if no choice is made, the customer continues with the existing supplier.

Table 1 **KN Energy Consumer Choice Supplier Selection**
Year 2000 Participation

Source: http://www.kne.com/service/KNE/ChoiceGasOutNeResCom.html
http://www.kne.com/service/KNE/ChoiceGasOut.html

Supplier	Residential/ Commercial Customers	Agricultural Customers
KN Gas Services	37,904	3,629
KN Energy	29,891	1,454
KN Affiliated Suppliers	67,795	5,083
PACE	16,996	296
Oneok	1,236	220
Midwest United Energy	617	3,188
Post Rock Gas	81	1,244
Total Customers	86,725	10,031

KN Energy has continued to send out one bill. On this bill are the charges for the services KN Energy continues to sell—the use of the pipe delivery system, meter reading, responding to gas leaks and maintaining a safe and reliable gas supply. Also, KN Energy continues to provide budget billing to all customers regardless of their supplier. On the bill is a separate line reflecting the customer's costs of gas purchased from its supplier. The agricultural choice program also includes an annual fee reflecting Kinder Morgan costs.

Below is an illustration of a bill supplied on KN Energy's web site. It shows KN Energy's distribution charge for delivering the gas is separate from the charge for the gas purchased

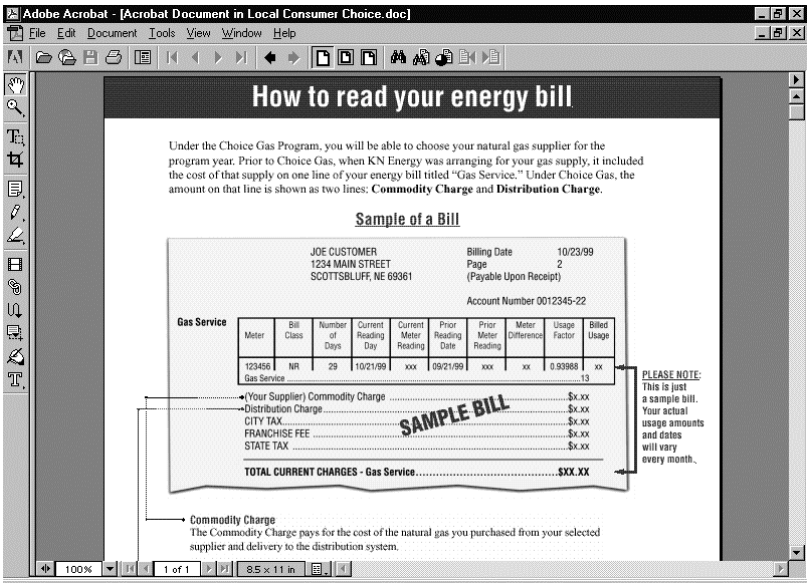


Figure 4

Source: http://www.kne.com/

by the customer from his or her supplier.

KN Energy determined the distribution charge using a modified net cost method. It took the gas supply rates as they existed before the Choice program was initiated and subtracted the cost of gas. This residual rate adjusted to include certain surcharges (such as for the P802 take-or-pay costs) that were transferred from gas costs into the delivery charge became the KN Energy distribution charge.

KN Energy and its affiliate gas marketer were chosen by 78% of the customers. The remaining 22% of the customers signed up with five other gas marketers. PACE is the sole publicly-owned gas supplier among these five. These marketers and suppliers had to deliver gas over the KN Energy gas delivery system. Upstream from that the KN Interstate pipeline's capacity reserved for KN Energy was assigned to these marketers.

The savings to the customers arising from KN Energy's Choice program appears to be small. KN Energy's web site claims a savings of $5 million was realized in the first two years. However, that saving was not calculated to recognize the shifting of the surcharges from the gas cost to the distribution charges. If this offset had been taken into account, the net savings would be very small, if any exists.

The KN Energy Consumer Choice program appears to be operating similarly to those in other parts of the United States. About 20% of the customers have selected suppliers other than KN Energy and its affiliate, KN Gas Services. Also, the financial savings to residential and commercial customers has been negligible.

Neither of these small numbers indicates the KN Consumer Choice program is not working. About 20,000 customers choose to exercise their rights as consumers and buy from a new gas supplier. They show a certain, but limited, acceptance of consumer choice. Even if savings are not apparent, the customers may simply be showing a preference for other terms and conditions offered by these other gas suppliers. And the 80% who stayed with KN may be choosing the plan that best suits their needs. The KN Consumer Choice program has begun much like other successful program across the United States. No doubt

improvements can be made as it stands up to the severe test today's high gas prices are bringing to the natural gas utility business.

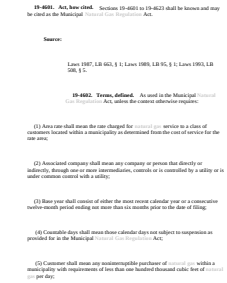
CHAPTER 8

Regulatory Recommendations

EFR Ltd. Offers Two Alternative Regulatory Recommendations

Earlier the operations and effectiveness of Nebraska's unique Municipal Natural Gas Regulatory system was examined. A number of weaknesses were shown, which are summarized below. Larger cities and towns work around the area rate proceedings by directly negotiating with the utilities to resolve rates. However, the municipalities often expect a financial incentive in return for settling the case. Smaller towns and villages, by their own

Nebraska Municipal Gas Regulation



19-4601. Act, how cited. Sections 19-4601 to 19-4623 shall be known and may be cited as the Municipal Natural Gas Regulation Act.

Source:

Laws 1987, LB 663, § 1; Laws 1989, LB 95, § 1; Laws 1993, LB 508, § 5.

19-4602. Terms, defined. As used in the Municipal Natural Gas Regulation Act, unless the context otherwise requires:

(1) Area rate shall mean the rate charged for natural gas service to a class of customers located within a municipality as determined from the cost of service for the rate area;

(2) Associated company shall mean any company or person that directly or indirectly, through one or more intermediaries, controls or is controlled by a utility or is under common control with a utility;

(3) Base year shall consist of either the most recent calendar year or a consecutive twelve-month period ending not more than six months prior to the date of filing;

(4) Countable days shall mean those calendar days not subject to suspension as provided for in the Municipal Natural Gas Regulation Act;

(5) Customer shall mean any nonexemptible purchaser of natural gas within a municipality with requirements of less than one hundred thousand cubic feet of natural gas per day;

Problem Areas

- Limited Municipal Authority
- Lack of Expertise
- Time Limitations
- Lack of Organization
- Funding Hiatus

observation, have not been effective in regulating rates. The municipal officials and employees needed to organize and carrying out an area rate proceeding has become frustrated and disinterested in participating. Part of this frustration and disinterest comes from the Nebraska Municipal Natural Gas Regulatory Act itself. The Act provides the municipalities with only limited, very weak regulatory authority and powers, and no powers of enforcement. Also, the area rate proceeding is very hard to organize and carry out. First, 70% of the municipalities in a rate area must agree to proceed. That can be difficult when many small towns and villages scattered along miles of state highways must agree to participate. Even after the municipalities are successfully brought together, it is difficult to keep them working as a team. Each has its own agenda, its own limits on available time, and conflicting demands for personnel and resources. Finally, the utility acts to divide the municipalities and arrange separate rate agreements with the municipalities with the weakest will.

The result is both the larger cities and towns, and the smaller towns and villages, find the Nebraska Municipal Natural Gas Regulatory area rate proceeding does not work. The difference is that the larger cities and towns have the staff and organization to resolve the rate questions by negotiating a mutually accepted result. The small towns and villages are not equipped for this. The resulting rates do not appear to be set with the public interest as the foremost objective of the process. Instead, the rates arrived at are a compromise based on the will and strength of the municipalities involved.

One important area overlooked because of a lack of centralized regulatory authority or clearing house is involvement in Federal regulatory proceedings. These proceedings directly affect the costs of gas supplied to Nebraska LDC's, and the costs of moving this gas into Nebraska. Some recent Federal regulatory activities in which Nebraskans should be at the table are listed below. Nebraska participation in FERC proceedings would advance the public interest by bringing them before the powerful Federal regulatory authority making the national policy toward natural gas.

Federal Interventions Overlooked by Municipal Regulation

- Kansas ad valorem taxes
  - Northern will receive $52 million. 13% should go to Nebraska LDC's. KN's claims are still in negotiation.
- Order 637 filings
  - Implementation of pipeline scheduling, balancing and capacity release being negotiated with LDCs and industrial customers
- FERC rate cases:
  - Each pipeline will file rate cases in the next year or two to determine rate levels and designs.

Figure 1

Also, Nebraskans could assure that LDC's actively represent the interests of their customers. An example is Neligh's attempt to gain transportation capacity to serve its newly acquired gas property before the FERC. Neligh had condemned the KN Energy gas property within the

municipal limits. To supply the Neligh Gas System with gas, Neligh needed pipeline capacity from KN Energy's pipeline affiliate. The pipeline refused to grant Neligh transmission usage, and the FERC refused to order KN's pipeline to surrender the capacity. Obviously, the interests of the Neligh customers and KN Energy were opposed.

Municipal regulation is unable to provide a strong regulatory presence, because of its inherent limitations. First, the Regulatory Act creates a very weak regulatory structure. It has not been able to enforce regulatory compliance with its rate ordinances, to check that gas costs are properly be charged in the purchase gas cost clauses, to provide continuous surveillance of utility rates and services because of a lack of reporting and accounting compliance, and lacks staffing. Second, its decisions are subject to de novo review by the courts. Within the last year, this direct barrier to municipal regulation has appeared. The Municipal Loan Fund, because of the actions of KN Energy, has no funds by which municipal regulatory action could be funded.

There is an even more fundamental lack than ratemaking powers, because these do operate, even if awkwardly. The greater concern is the fundamental regulatory function that does not work in Nebraska—the function of putting the customer and the utility on equal footing before an independent body so that disputes can be heard and settled efficiently and effectively.

An example of this fundamental weakness of the Nebraska municipal regulatory system can be seen in Broken Bow. During this last spring[1] the City of Broken Bow and KN Energy became involved in a service dispute and safety controversy when the City tapped into the city's service line and resold gas to a local industry. KN Energy had no independent regulatory agency to turn toward to resolve the dispute. The City was part of the dispute. The City had no authority to turn to when KN Energy refused to sell it the gas Broken Bow was reselling. The dispute ended up in court instead of before a regulatory agency with industry expertise and the procedural power to resolve the dispute. As energy industry conflicts become increasingly multi-party disputes, judicial procedures become even less effective at resolving them.

The recent allegations with regard to Peoples Natural Gas Co.'s cost allocations of gas costs appearing in the early December World-Herald and Journal-Star are another example of a regulatory void. Though a number of states had the personnel and authority to look into the issue, Nebraska was without any obvious agency to investigate the issue.

This does not say state regulatory agencies resolve all problems and satisfy all parties, but all parties have a forum to which they can bring their disputes. These disputes might involve all kinds of customers--the single customer with a service dispute or billing problem, the developer who has a question about getting service to a new subdivision, or the city interested in gas service to support its economic development projects. A key role of

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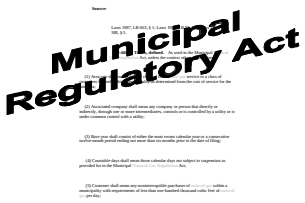
[1] "Verdict still out in KN court case," Custer County Chief, Apr 7, 2000. "Judge orders Walter to staff off Kinder Morgan property," Custer County Chief April 20, 2000. "Bow joins legal fight with KN, consultant," Custer County Chief, May 5, 2000.

regulation is to level the playing field and give customers a voice that can speak load enough for the utility to hear it. This voice needs to be heard, whether in major proceedings like traditional rate cases, or in more day-to-day service and bills disputes phoned in by individual customers.

This forum also serves the utility and the community well. It provides an intermediary that can resolve independently, in an evenhanded objective manner, disputes brought to the utility. The utility has a means to avoid appearing heavy-handed with a customer, or being pressured to favor one customer over another. The regulatory forum is not a system to rubber stamp the utility's position, but a forum that should consider all arguments and resolve the disputes in a fair and reasoned manner.

This forum is missing in Nebraska. Regulation of gas utilities is scattered throughout state agencies, among municipalities and into the courts. If one thinks of the regulatory agency as a means for resolving disputes, anywhere on the spectrum from informal phone calls to intractable industry-wide problems the regulatory void in Nebraska can be seen to be very

Nebraska Municipal Gas Regulation: What Do You Have Now?



- Limited Jurisdiction
  - Industrial and rural customers not protected
  - Not equipped to promote competition
  - Not able to supervise gas marketing
- Part-time regulatory role of city councils
- Many municipalities setting rates
- Judicial appeals continue to cloud rate proceeding

large.

EFR Ltd. is proposing two alternative recommendations to the Urban Affairs Committee—the establishment of a regulatory agency to oversee gas utilities in the state, or a strengthening of municipal regulatory authority. Both should be focused on mending the shortcomings inherent in the present municipal regulation system summarized in the graphic above and discussed in detail in earlier chapters.

Nebraska Natural Gas Regulatory Board

This Gas agency would have authority over rates, service and the terms and conditions of service. The following diagram showing the span of this authority contrasts with the slim

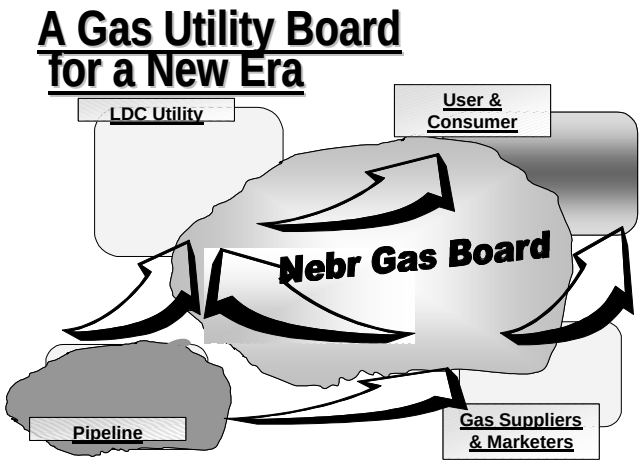


Figure 3

dimensions of the very restricted regulation exercised currently under municipal regulation.

The regulatory authority needs to have the traditional authority over rates and services of the gas utility with a monopoly. But it also needs to cope effectively with controlling the growing

Regulatory Role With Consumer Choice

- Set rules for the weakly competitive gas market when only a few marketers enter
- Protect consumers by
  - Informing consumers
  - Allowing consumers to switch suppliers
- Promoting competition among multiple sellers
  - Set marketer qualification
  - Monitor gas sales by LDC or affiliates
- Protect against abuses and fraud by LDC's or Marketers
- Determine when LDC's must back stop gas supply shortages

gas supply market, where a number of gas suppliers contest for customers. Some of the assignments this gas agency should be given are outlined above.

There are several options for the configuration of a gas regulatory agency. First, its staff level can be kept to the smallest size needed for its base line workload. This option assumes this overflow workload, such as major rate cases, will be met through use of consultants. A larger permanent staff provides more continuity and better development and retention of expertise.

Second, the agency' assigned functions can include advocacy or not. Staff presented positions assure more complete development of records for decision, but introduce the need to manage potential internal conflicts of interest so that staff advocates do not have an "inside track" to the agency's decision makers. In one policy alternative, municipalities would retain much of the advocacy role.

The municipalities' involvement in gas utility regulation does not end, but is redirected toward representation of consumers. The municipalities could be given the right to intervene and participate in gas cases, both on their own behalf and on behalf of their citizens. Their role

Figure 4

could be funded though a reconstituted Municipal Loan Fund with mandatory assessments against the utility, the utility to be repaid by utility collections from ratepayers.

Third, the new agency's skill set should be configured to the functions assigned to the agency in the legislation. Personnel with the traditional regulatory disciplines of accounting, law, rate analysis, and engineering are important, but the staff also will need to include skills in economics, market analysis, policy development, dispute resolution, and consumer education. The key to formation of a staff should be the ability to relate these skills to changing market situations, keeping the big picture in view.

Depending on the legislative choices, an agency could operate with as few as eight to ten full time staff members. To be fully sufficient, it would require between twelve and

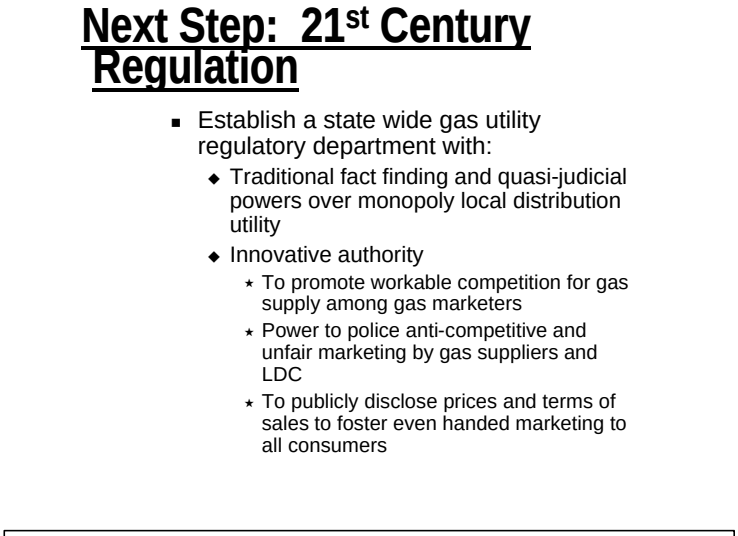


Figure 5

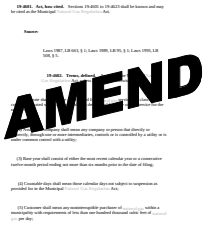
fifteen full time positions. A realistic support budget would also be required.

Creation of a new agency with authority over natural gas utilities and assignment to it of authority for natural gas rates is the alternative best suited to the modern requirement of an increasingly competitive industry. This alternative also meets the public's need for continued traditional regulation of the LDC rates and services, and provides oversight and control to promote competition for selling gas supply services to customers. The gas regulatory agency should be able to enforce fair dealings between the LDC, affiliated gas suppliers and independent gas suppliers, plus provide information and protection to consumers who otherwise might face marketing and sales abuses.

Empower Municipal Regulation

Alternatively, the Unicameral may choose to strengthen the municipal regulatory system that now exists. Some of the changes that would empower municipal regulation include the following:

Nebraska Municipal Gas Regulation



Minimal Repairs

- Increase Municipal Authority
- Make Statutory Changes
- Provide Permanent Oversight Board and Staff
- Provide Enforcement Powers
- Provide Continuous Surveillance and Reporting
- Refunding of Municipal Regulation

Figure 6

Doing only these revisions to the municipal regulatory system would reinforce the ratemaking function, as it now exists. Even if rate regulation were made water tight, the lack of significant regulation of service and complaint resolution would continue. However, the limitations of municipal ratemaking would continue in major ways. First, the need for the municipal regulation to face de novo appeals when decisions are appealed to the courts might not go away. Second, the capability of the municipals to oversee consumer choice programs, the increasing participation of gas marketers and to offer consumer protection and education is problematic at best.