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One consequence of the revolutionary changes which have swept the natural gas industry over the past half decade has been the increased prominence of utility commissions of major consuming states. In very broad terms, two developments—the emergence of a "buyer's market," characteristic of an excess of supply relative to demand, and the progressive dismantling of the apparatus of pervasive and detailed regulatory controls at the federal level—have served to add both to the responsibilities of individual state Public Utility Commissions (PUCs), and to their ability to influence the workings of gas markets not only at the state level, but also at the regional, national and even international levels as well. This is so because the state commissions very largely continue to set the conditions which competing suppliers (be they interstate pipelines, gas producers or brokers and marketers) must meet in order to gain access to the facilities of local distribution monopolies, the last link in the transportation infrastructure through which gas moves from wellhead to burner tip. The position of such agencies thwarts the flow of interstate and international commerce in natural gas, and the power they exercise to control and direct that commerce to their own ends, imposes an important (albeit too often overlooked) qualification on the commonplace presumption that a free and unregulated market for gas as a commodity is emerging in this country.

Perhaps nowhere is the ascendancy of consuming state PUCs more evident than in the case of the California Public Utilities Commission (CPUC). The decisions of this one agency affect in a most direct and vital way the fates of individual producers, royalty owners, service companies, banks, pipelines, brokers and marketers, and local taxing authorities—in short, virtually every entity with a stake in the exploration for, and the production, transportation and sale of natural gas—throughout a vast region encompassing roughly the western one-third of the United States and Canada. The purpose of this article[1] is to draw attention to the CPUC's extraordinary "extraterritorial" influence in western gas markets,

1. This article was adapted from remarks delivered by the author at a conference held on Nov. 6, 1986, in Albuquerque, N. Mex., under the auspices of the University of New Mexico's Institute for Public Policy.

to try to explain the reasons for it, and to convey some sense of what it means.

California is far and away the largest gas market in Western North America, and one of the largest in the United States as a whole, accounting for roughly ten percent of total U.S. consumption. Depending on how the demand for gas develops in Enhanced Oil Recovery (EOR) operations in the heavy oil producing region of central California, California's gas requirements, after a long decline, could recover somewhat over the next ten years and ultimately stabilize at roughly 5 billion cubic feet per day (bcf/d) assuming normal weather and hydro conditions and no significant fuel switching.

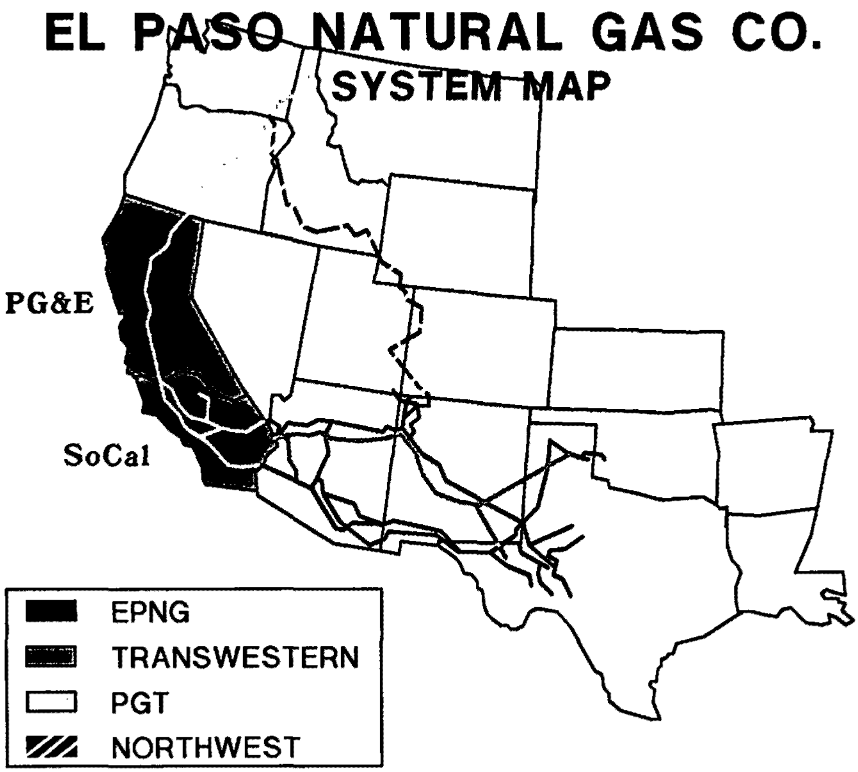
At present levels of consumption, in-state and adjacent offshore gas production, although substantial in absolute terms, are sufficient to meet only a small fraction—roughly fifteen percent—of California's need. The rest must be "imported" from other states and from Canada. As shown on the attached map, California's need to import has largely dictated the present configuration of the pipeline grid in the West.

The El Paso and Transwestern interstate pipelines between them presently have capacity sufficient to move 3.6 bcf/d to the Arizona-California border from New Mexico, Texas and Oklahoma, while the pipeline running south from Alberta to San Francisco (the interstate segment of which is owned by Pacific Gas Transmission) is sized to move approximately 1 bcf/d of Canadian gas. Importantly, when measured against present market demand in California, the existing pipelines serving the state exhibit substantial excess capacity during off-peak periods.

In addition to the sheer size of the California market, the CPUC's influence derives from the concentration of significant market power in the hands of California's two primary gas utilities. The gas market in California has been divided geographically between Pacific Gas and Electric Company (PG&E), which operates in the northern and central portion of the state, and Southern California Gas Company (SoCal Gas), which operates, of course, in southern California (see Map). Within their respective service territories, SoCal Gas and PG&E exercise absolute monopolies over essential transportation facilities, and hence absolute control over the price and terms of market access.[2] The CPUC, in turn, through its regulatory authority over the utilities, effectively directs the exercise of the utilities' market power.

Historically, the CPUC's predominant concern has been to keep base rates for residential users as low as possible. And it has become very sophisticated in using the utilities' market power to that end. In the late

2. Indeed, Pacific Gas Transmission, one of the three interstate pipelines serving California, and the only such pipeline through which producers in Canada have direct access to the California market, is a wholly-owned subsidiary of PG&E.



1970s, when energy supplies were tight and prices rising, the CPUC adopted value-of-service based rates for large-volume industrial and Utility Electric Generation [UEG] users. The net result was that the rates paid by such users were subsidizing residential rates. This amounted to a form of taxation of one set of end-users within the state for the benefit of another. More recently, when falling oil prices began to squeeze the utilities' margins on industrial and UEG sales, the CPUC redirected the exercise of the utilities' market power to force supplier price concessions as a means to maintain the residential subsidy. In effect, the CPUC sought to shift the tax burden to suppliers, including out-of-state suppliers.

Two related developments made it possible for the CPUC to use the utilities' market power to force lower prices from suppliers. By the early 1980s, the natural gas shortages of the previous decade had given way to a substantial and persistent surplus. Moreover, beginning in 1984 with its Order No. 380[3] and in subsequent orders, the Federal Energy Regu-

3. Order No. 380, Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, 49 Fed. Reg. 22,778 (June 1, 1984); *order on reh'g*, 49 Fed. Reg. 31,259 (Aug. 6, 1984), *aff'd*, Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985).

latory Commission effectively freed the California utilities of any continuing purchase obligation to their traditional interstate pipeline suppliers. The utilities, under the CPUC's prodding, were quick to seize upon the opportunities these developments presented to set suppliers against one another as a means to secure price concessions.

Until very recently, in addition to their transportation monopolies, the California utilities were also monopsonist purchasers of gas at wholesale and monopolist sellers of gas at retail. However, over the last twelve months, their traditional service function, at least as to so-called "non-core," large volume consumers, has been "unbundled" into its transportation and merchant components.[4] The utilities remain monopolists as to transportation, but the implementation of the CPUC's mandatory carriage program now makes it possible for other buyers and sellers to compete with SoCal Gas and PG&E in performing the merchant function in the non-core segment of the market.

Even so, it is important to recognize that the implementation of mandatory carriage in California does not limit the power of the utilities to secure supplier price concessions. The utilities still are, and likely will continue to be, the dominant purchasers and resellers in their respective market areas. They retain their positions as monopsonist purchasers on behalf of "core" customers. And as to the non-core market, rather than demanding lower prices from suppliers, the utilities can now demand higher carriage rates. The impact on supplier net-backs is the same in either case.

On December 3, 1986, the CPUC issued final policy statements in two important rulemakings: one—the so-called "OIR" proceeding—involving industry structure (to include the division of the market into core and non-core segments, guidelines for utility supply acquisition on behalf of core customers, and the unbundling of service options for non-core customers),[5] and the other—called the "OII"—to establish the basis for division of the utility margin (utility non-gas costs and pipeline demand charges) between core and non-core, as well as the non-core rate design.[6]

4. At the risk of over simplifying an otherwise complicated process, "unbundling" refers to the disaggregation of traditional utility service into two or more individual elements, each of which is then offered to consumers on a "stand alone" basis. (*E.g.*, the CPUC has thus far taken the disaggregation process to the point of requiring the California utilities to offer separate "transmission" and "procurement" services to non-core customers. The question of whether the utilities' storage services should also be offered on an unbundled basis to non-core users is still being debated.) Simultaneously, the utilities' total costs are also unbundled such that, in theory at least, the rate charged for each separate service reflects only those costs which are directly assignable to that service plus an appropriate share of common costs. The goal of unbundling is to permit the individual consumer to choose to receive only those elements of traditional utility service which it values at least as much as the cost thereof.

5. California Public Utility Commission, Decision 86-12-010 (issued Dec. 3, 1986).

6. California Public Utility Commission, Decision 86-12-009 (issued Dec. 3, 1986).

Further evidentiary hearings were scheduled during the summer of 1987 to implement the policies adopted in the OII. The outcome of these proceedings will effectively determine whether to continue a "tax" for the benefit of residential rate payers, how much the tax will be, and who will pay the tax in the current market environment.

In sum, because of the size of the California gas market relative to other potential markets in the West and the virtually absolute control which the CPUC exercises in defining the conditions of access to that market, the CPUC has been able to seize upon the opportunities presented by the nationwide surplus of supply relative to demand and changes in federal regulation to force reductions in delivered gas costs at the California border. Again, however, the CPUC's power *vis a vis* upstream suppliers derives from the utilities' transportation monopolies, and it is perhaps here that that power is most susceptible to effective challenge. As a consequence, the CPUC vigorously defends those monopolies against any and all threats to introduce competition into the market for transportation services within California through the construction of a new interstate pipeline into the state.

Two alternative proposals to build such a pipeline to serve the emerging EOR market in central California are now pending before the Federal Energy Regulatory Commission, and others have been discussed from time to time. The construction of an interstate pipeline into California could change the entire complexion of the western gas market. Along with its historic concern to minimize residential rates, blocking such construction is a matter of the highest priority with the CPUC. For example, the CPUC's adoption of mandatory carriage of customer-owned gas for non-core customers was motivated in major part by its desire to woo those large-volume users away from supporting the construction of an interstate pipeline.

Whether the CPUC will ultimately succeed in stopping a new pipeline from entering California is still very much in doubt. Perhaps its strongest argument is that there is already in place within California a substantial gas transportation system which can be expanded when necessary to meet increased future needs for capacity at lower cost than would be involved in the construction of a wholly new pipeline. On the other hand, perhaps the greatest hurdle the CPUC faces is the element of distrust, borne of experience among both large-volume consumers and their potential suppliers, that CPUC is mainly interested in blocking a new pipeline because it sees in such a pipeline a direct threat to its ability to continue to extract monopoly rents from non-residential customers for the benefit of the residential class.

In any event, for the time being, whether a new pipeline is ultimately constructed or not, the CPUC remains a major day-to-day focus of attention for western gas suppliers. Although its influence has expanded far beyond California's borders, the CPUC's concern is not ultimately with the continued health and well-being of entities involved in gas exploration, production and transmission. As a consequence, its decisions in the recent past have tended to emphasize short-term price minimization even at the expense of long-term supply security. For example, in one recent decision,[7] the CPUC was quite blunt in stating that it "is not in the business of protecting pipelines and producers."

One other aspect of that particular decision is also worthy of note. The CPUC there dismissed substantial, unrebutted evidence that PG&E in its purchase was favoring Canadian gas delivered through its interstate subsidiary over gas which was otherwise available from domestic producers across the El Paso system at no greater cost to PG&E's ratepayers. The clear message was that the CPUC was not concerned that the utilities might use their monopolies to favor affiliated suppliers over non-affiliates so long as California ratepayers are not disadvantaged.

CONCLUSION

The example of the CPUC represents in boldest terms the recent ascendancy of consuming state commissions in the natural gas industry. Although relatively little discussed, the shift in relative influence to these agencies in worthy of careful consideration. Certainly entities which have important stakes in the industry in the Western United States and Canada can no longer fail to understand and appreciate the CPUC's newfound importance. To a very substantial degree, their fate is now in the hands of this one agency. The words of a popular country and western song comes to mind: "It don't matter where you played before, California's a brand new game."

7. California Public Utility Commission, Decision 86-06-066 (issued June 4, 1986).