

FLEXIBLE PRICING AND OTHER PARTIAL SOLUTIONS TO THE PROBLEMS FACED BY GAS DISTRIBUTORS

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During the last two decades, sudden and major shifts in market conditions have characterized the natural gas industry. Currently, declining demand for natural gas is at the heart of many problems faced by the natural gas industry and, particularly, natural gas distributors. The unforeseen success of conservation efforts and competition from alternative fuels¹ appear to be significant causes of diminished sales. It is interesting to contrast the present difficulties with those of the recent past. As recently as the late 1970's, the pipeline industry grappled with the problems of obtaining enough gas to satisfy the needs of industrial customers. Today, it must struggle to retain enough customers to use the present deliverability of gas. Tomorrow, there are some indications that gas supply shortages will recur.

In the 1970's, federal rate design policy, applicable to the interstate pipelines that supply distributors, reflected a general desire to *decrease* gas sales by shifting fixed costs² toward interruptible and high volume industrial users. In 1973, when the Federal Power Commission mandated the *United* rate design,³ it shifted certain fixed costs to the commodity charge, thereby discouraging gas use by interruptible, seasonal, and industrial gas users because of the gas shortage. The overwhelming concern of pipelines and distributors, at that time, was how to obtain enough gas for commercial and industrial customers. In the 1970's, the Federal Power Commission had only limited means available by which gas could be moved to supply-short areas in the country from well endowed areas.

Today, there is a surplus of gas, and the problem is a lack of purchasers. Regulators and pipelines are searching for rate designs which will reverse this process and enhance the market-ability of gas to industrial customers. The focus is not on allocating additional fixed costs to those customers, but on whether those customers can be retained by requiring that they make only minimum contributions to the fixed costs of distributors and pipelines.

It is hoped that the industry and its regulators have learned from the rapidly changing events of the past decade that regulatory responses should not outlive the conditions which spawned them. The natural gas industry is threatened by a reflexive groping for short-term solutions, which become embedded as precedents and thus create new problems when gas markets change. Indeed, even as the system struggles to find solutions to the declining demand for gas, which was caused in part

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¹An estimated 52% of sales to industrial markets are to customers with a dual fuel capacity. American Gas Association, Survey of Industrial Fuel Switching and Alternative Fuel Capacity: 1981-82 Update at 5 (September 3, 1982).

²Fixed costs are not subject to change in the short-run and traditionally include depreciation, interest on and amortization of debt, return on equity and associated income taxes, labor expenses, franchise taxes, property taxes and like costs.

³The *United* rate design classifies 25% of a pipeline's fixed costs to the demand function and 75% to the commodity function for classification and allocation purposes. Opinion No. 671, United Gas Pipeline Company, 50 F.P.C. 1548 (1983), Opinion No. 671-A, 51 F.P.C. 1014 (1974), *aff'd. sub. nom.*, Consolidated Gas Supply Corp. v. Federal Power Commission, 520 F.2d 1176 (D.C. Cir. 1975).

by recession, Merrill, Lynch, Pierce, Fenner & Smith, Inc. has predicted that a new era of supply curtailment will arrive in the mid-1980's.⁴ Because gas market conditions have proved to be subject to great and sudden changes, the most appropriate solutions to current problems should not prevent flexible responses to future crises.

By focusing on the problems of responding to today's market, this Article documents the need for a new approach to the regulation of the natural gas industry, which must be applied to producers, pipelines and distributors. Such a new approach must be less ossified, more responsive to market aberrations and more competitive. This new approach must respond today to sales, which, in large part, have declined because of increased competition throughout the energy sector. If the industry cannot keep dual-fueled customers on gas, it may be doomed to shrink rapidly, never to expand again. However, if the solutions focus only on the short-term problems, the industry may ignore the longer-term problems, which threaten fundamental structural changes in the industry.

I. FLEXIBLE RATES FOR DUAL FUEL CUSTOMERS: THE BACKGROUND

Despite the fact that significant numbers of large volume customers are capable of using different fuels interchangeably, gas prices traditionally have not been responsive to demand in volatile markets. The ratemaking procedures commonly employed at the federal and state level have been inflexible and incapable of responding to interfuel competition, to the detriment of customers who are not capable of switching to other fuels and who therefore must bear an increasing proportion of fixed costs.

Traditionally, the price of gas, particularly the share of fixed costs, charged to each class of customers has reflected the concept of a fully allocated cost-of-service.⁵ Cost-of-service pricing is based upon supply factors and is designed to recover operating expenses, depreciation expenses, taxes and a reasonable return on the net investment and property of the gas distributor. It is, therefore, "demand inflexible" — it cannot adjust to a market in which customers have an economically attractive alternative to gas. Furthermore, although rates are established by company-filed tariff applications, such rates often cannot be implemented until the completion of extensive, time-consuming state regulatory hearings.⁶

When sales to such "dual fuel" customers are lost by a distributor or pipeline, fixed costs must be allocated among fewer sales volumes, resulting in higher rates for those without dual fuel capability. Traditional teaching therefore suggests that a rate design which produces any contribution to fixed costs by customers who would otherwise be lost is beneficial to all of the distributor's or pipeline's ratepayers. Flexible pricing for industrial users attempts to translate this traditional teaching into a rate methodology which retains industrial load to benefit the utility's system.

Before analyzing some of the particular problems involved in setting competitive rates within a regulated market, it is important to recognize three shortcomings of this traditional analysis. First, the fatal flaw in state-level solutions is that there is little that one can achieve by allocating fixed costs among customer classes, when fixed costs have declined in relative importance. Gas costs now consist of 75% to 80% of the burner-tip price of gas, so innovative rate designs and flexible pricing options approved by state commissions are of limited utility. Such approaches may be incremental aids which, in the short-term, will retain some gas markets.

⁴Merrill, Lynch, Pierce, Fenner & Smith, Inc. "Natural Gas Monthly," June, 1983, at 1.

⁵American Gas Association, *Regulation of the Gas Industry*, Ch. 40 (1981).

⁶*Id.*, Ch. 41.

However, in the long-run, they alone cannot preserve the competitiveness of gas with alternative fuels.

Second, short-term solutions such as innovative rate designs and flexible pricing focus predominately on alternative fuels. They have little effect on decreases in sales due to conservation.

Third, classical microeconomic theory suggests that, in the short-run, a product should continue to be produced, supplied and sold, if the price it commands in the marketplace is sufficient to recover all variable costs of production and distribution and to make any contribution to sunk fixed costs. Further, fashionable theorists add an incremental pricing analysis to this argument, claiming that interruptible users impose no fixed cost requirements and, hence, should not be allocated a share of fixed costs. However, such theories may not be helpful in the long-term and, indeed, can obscure the problem. If marketing problems are irreversible over the long-term, short-run solutions may worsen matters. Even if continued service may not require additional construction, when supplies are added, additional "sunk costs" are incurred. "Cheaper" old gas is depleted, and replacement volumes may carry the potential for significant prepayment obligations. In addition, incremental pricing theory is easier to articulate than to administer. Any class of customers can be viewed as incremental and any class of customers can claim that it will go elsewhere for energy, if its costs are not lowered. Is a condominium development that threatens to put in electric heat pumps an incremental market? An industrial user not yet having dual-fuel capacity? A distributor with multiple suppliers? If everyone can be viewed as an incremental user if the time-frame is expanded enough, what class of users ultimately will pay the distributor's fixed costs?

Despite these criticisms, as the industry buys time to develop longer-term solutions, reconciling traditional cost-of-service pricing with value-of-service pricing may be an important palliative to the immediate problem. Flexible rates may provide such a reconciliation. A flexible gas rate is one that fluctuates in a stated fashion with the price of an alternative fuel. As the Illinois Commerce Commission has noted:

The major problem with inflexible rates is that they would be adequate only some of the time to fulfill the purposes of maintaining the load and assuring an appropriate contribution to the costs and profits by large-volume customers. For the rest of the time, the inflexible rates would either be too high — and Respondent would lose load and revenue — or too low and large-volume customers would make a lower contribution to costs and profits than would be afforded by a flexible rate . . . [I]t is difficult or impossible to forecast oil prices under present conditions.⁷

By fluctuating with the price of alternate fuels, flexible rates can eliminate the immediate financial incentive for dual capacity customers to switch away from gas. The contribution to fixed costs from the retained sales arguably reduces the rates which otherwise would be paid by all customers. Because of these contributions, the increasing price competitiveness of alternate fuels has led to an increased use of flexible pricing for dual fuel customers at the state level.⁸

⁷The Peoples Light Gas and Coke Co., Ill. C.C. Docket No. 82-0082, *mimeo* (December 28, 1982).

⁸A recent study found that gas distributors in all regions of the country foresee a need for flexible rates within the next four years. American Gas Association, AGA White Paper on Gas Distribution Industry Ratemaking Options (White Paper) at 22 (April, 1983).

II. FLEXIBLE RATES: THE LEGAL AUTHORITY

Cost-of-service is the traditional basis in establishing rates and rate designs. Nonetheless, legal authority dating from the beginning of this century to the present has recognized that value-of-service can be a valid, even superseding consideration.

Value-of-service has long been recognized as a proper factor in establishing rates for different classes in the transportation field. In 1915, the Supreme Court held that neither uniform rates nor the same percentage of profit are required for all classes of service.⁹ It also held that value-of-service could be considered in setting railroad rates.¹⁰ There is also judicial support for regulatory discretion, in the transportation industry, to allow price differentiation based on the benefits of scale in transporting large volumes.¹¹

Authority also exists for setting rates which reflect value-of-service in the natural gas industry. Most state utility statutes provide that rates for a particular class may not be "unduly" preferential or discriminatory.¹² They thus implicitly recognize that some considerations other than the arithmetic allocation of a utility's cost-of-service may be utilized. The need to retain some level of purchases by dual fuel customers is such a consideration and can provide a rational basis for allowing a special, flexible rate. State regulators have this flexibility because the standard for review of commission-approved rates and classifications is usually whether the commission had a rational basis in law and fact for its decision, rather than a statutorily-mandated regulatory theory. Precedent under the Natural Gas Act gives the Federal Energy Regulatory Commission considerable flexibility in designing rates.¹³

Several state courts have recently held that factors other than cost-of-service can be considered in setting rates. In *Washington Gas Light Co. v. Public Service Commission*, the court held that non-cost factors which may be considered in setting rates for interruptible customers include the value-of-service and the competitiveness of the gas rate with the price of available alternate fuels.¹⁴ It reasoned that, although gas utilities enjoy regulatory protection to some degree, the present reality of price competition may be considered in reviewing the reasonableness of a rate structure.¹⁵ Similarly, the decision of the New York Public Service Commission that economic costs are not "the only lawful criterion for establishing just and reasonable rates" has been upheld upon review.¹⁶

Some state courts have accepted rate designs based entirely upon value-of-service. The Kansas Court of Appeals, taking judicial notice of the current conditions in the gas industry, held in 1979 that a rate design which is fair on its face and which is based upon substantial evidence, need not be based upon a cost-of-service study.¹⁷ In *C.F. Industries v. Tennessee Public Service Commission*, the Tennessee Supreme Court held that "there is not a requirement in any rate case that the Commission receive and consider cost of service data."¹⁸ Thus, it is not surprising

⁹*Northern Pacific Railroad Co. v. North Dakota*, 236 U.S. 585, 598-99 (1915).

¹⁰*Id.*

¹¹*See, e.g., East Tennessee, Virginia and Georgia Railway Co. v. I.C.C.*, 181 U.S. 1 (1901); *Texas and Pacific Railway Co. v. I.C.C.*, 162 U.S. 197 (1896); *National Gypsum Co. v. U.S.*, 353 F. Supp. 941 (W.D.N.Y. 1973).

¹²White Paper, *supra*, at 54 n. 5.

¹³*Fuels Research Council, Inc. v. FPC*, 374 F.2d 847 (7th Cir. 1967).

¹⁴450 A.2d 1187, 1204-05 (D.C. App. 1982).

¹⁵450 A.2d at 1205.

¹⁶*Lefkowitz v. New York Public Service Commission*, 40 N.Y. 2d 1047, 1048 (1976).

¹⁷*Midwest Gas Users Association v. State Corporation Commission*, 595 P.2d 735, 746 (Kan. App. 1979). *See also, Florida Retail Federation, Inc. v. Mayo*, 331 So.2d 308, 312 (Fla. 1976).

¹⁸599 S.W.2d 536, 542 (Tenn. 1980).

that many state commissions have approved flexible rates for dual fuel customers, as discussed in the following section.¹⁹

III. FLEXIBLE RATES: THE ISSUES

Many gas distributors have adopted rates which vary with the price of competitive fuels for dual fuel customers. Some have adopted other means of discounting the price of gas for customers that might otherwise switch to a less expensive fuel source. A recent survey of eighty gas companies serving 127 service areas (and sixty percent of the gas customers in the United States in 1981) found that twenty-seven companies have flexible rates in effect or approved for industrial customers, and twenty-four companies offer, or are authorized to offer, such rates to commercial customers.²⁰ In the former instance, the majority of companies offer the rate only for interruptible service, and in the latter, all but two companies impose such limitations on the availability of the rate.²¹

Responsibility resides in the gas distributor, who must propose a flexible rate for a defined class of customers in a tariff application which is subject to approval by the state commission.²³ In designing such rates, the distributor must address several key issues.

1. *The flexibility mechanism.*

How should the flexible rates be set? The essential choice is between indexing rates and contracting with individual customers for rates.

Most flexible rates which have been adopted or approved fluctuate with the price of an alternative fuel, such as fuel oil, residual oil, or propane, as taken from an approved government or private index.²³ In light of the length of regulatory proceeding in many states, special waivers of tariff requirements may be required to allow the rate to be adjusted periodically.

Other approved ratemaking mechanisms provide price flexibility by allowing distributors to negotiate price contracts with individual customers. A contracting approach to price flexibility is essentially a limited step toward deregulation.²⁴ It also provides for more accurate competitive responses because such a method "allows a company to remain flexible in evaluating the individual characteristics of each interruptible customer on its system . . . [resulting in] a price for interruptible gas

¹⁹See, e.g., *Re Washington Gas Light*, 52 P.U.R. 4th 1, 73 (D.C. P.S.C. Order No. 7749, Feb. 25, 1983); *Re Commonwealth Gas Co.*, 50 P.U.R. 4th 85, 120 (Mass. D.P.U. 1120, Nov. 20, 1982); *Re Orange and Rockland Utilities, Inc.*, 45 P.U.R. 4th 235, 250-51 (N.Y. P.S.C. Op. No. 81-24, Dec. 1, 1981); *Pennsylvania Public Utility Commission v. Philadelphia Electric Co.*, 33 P.U.R. 4th 319, 360 (Penn. P.U.C., Jan. 4, 1980).

²⁰White Paper, *supra*, at 13-14.

²¹*Id.* at 13.

²²Present ratemaking procedures can delay the implementation of flexible rates. In California, where the state PUC has approved flexible rates for two distributors, San Diego Gas and Electric submitted its 1984 rate proposal before the sharp increase in its gas prices in the spring of 1983. It now faces a serious problem of competition from alternate fuels, but will not be able to adopt a flexible rate until 1986.

²³Distributors need to exercise caution in proposing an index that will allow gas to be truly competitive with the alternative fuels available to their customers. For example, a widely available index, the Energy Information Administration posted index for heavy fuel oil, is a regional price index which does not track prices in local spot markets.

²⁴The AGA White Paper found that, of the companies having an opinion, an overwhelming majority favored industrial rate deregulation. White Paper, *supra*, at 19.

which is truly competitive with the price that each interruptible customer would have to pay for alternative fuel."²⁵

2. *Price Floors.*

What is a fair floor for gas rates? Obviously, all the incremental costs of the sale should be recovered. In California, for example, Pacific Gas and Electric has been authorized to use a flexible rate schedule for dual fuel customers, subject to an "economic curtailment provision" which disallows rates so low that revenues would not meet the incremental costs of service.²⁶ Similarly, the Equitable Gas Company in Pennsylvania offers a flexible rate tied to No. 6 fuel oil, which has as a floor the sum of current gas costs plus the Pennsylvania gross receipts tax.²⁷

Such minimum rates are appropriate on theoretical grounds. The purpose of keeping dual capacity customers in the market for natural gas is to retain some portion of their contribution to fixed costs which otherwise would be lost. When the incremental cost of serving flexible rate users exceeds revenues from the sales, no benefit to other customers accrues. In practice, regulators likely will require that sales under flexible rates make a contribution to fixed costs.

3. *Price Ceiling.*

A further issue is whether, in addition to a floor, there should be a maximum rate or "ceiling", such as the traditional cost-of-service price. It is arguable that customers allowed to purchase at below the fully allocated cost-of-service during periods when competitive prices are depressed should be required to purchase at a rate above a fully-allocated rate when competitive prices have risen. This is precisely the position taken by the Illinois Commerce Commission in approving a flexible rate for Peoples Gas Light and Coke Co.²⁸ Other distributors, however, have adopted ceilings. Niagara Mohawk Power Corporation, of New York, which offers a flexible rate to certain interruptible commercial and industrial users, limits the rate at the upper end to the tail block of the firm industrial rate.²⁹ Other ceilings could include the rate under which the industrials otherwise would have purchased or a rate which can fluctuate as much above the "base" rate as the discount rate can go below that base rate.

4. *Policing the rates.*

A distributor must insure that only dual fuel customers have access to the flexible rate and that rates do not go below the level necessary to retain sales. Inadequate policing could prompt state regulators to charge any underrecovery against return. A variety of means to accomplish this are available. A utility could require proof of the capacity to change fuels, evidence of available cheaper alternate fuels, and a signed affidavit indicating active consideration of changing fuels. The

²⁵Re Commonwealth Gas Company, 50 P.U.R. 4th 85, 120 (Mass. D.P.U., Nov. 30, 1982). However, a potential drawback of the contracting approach is that distributors may not have an opportunity to assess the alternatives of each flexible customer on a monthly basis, for contract negotiation purposes. Routinized procedures, such as affidavits from the customer and spot checking of information, should avoid both misrepresentation and time delays which could defeat the goal of competitiveness.

²⁶Cal. P.U.C. Docket # 8306004, *mimeo.* (June 1, 1983). At the time of this article, a date for implementation had not been set.

²⁷White Paper, *supra*, at 33.

²⁸The Peoples Gas Light and Coke Co., Ill. C.C. Docket No. 82-0082, *mimeo.* (July 14, 1983).

²⁹White Paper, *supra*, at 36.

utility also could require evidence of past consumption above a threshold and a signed affidavit that, without the discounted rate, the customer would cease to use or choose not to return to natural gas.

5. *Allocation of Profit and Risk.*

If flexible rates retain sales, how should any income above incremental costs be shared between the utility and its customers? Allowing the distributor a share in the profits from flexible rate sales may increase the volume of sales to dual fuel customers, but simultaneously it may diminish the contribution to fixed costs from such sales. Denying the distributor any profits removes the incentive to pursue such sales. Commissions have sought to determine the distribution of profit that will produce the optimal benefit to utility customers. No one answer has achieved predominance.

One extreme was adopted last year by the Massachusetts Department of Public Utilities in *Re Commonwealth Gas Company*.³¹ Because the distributor retained a portion of the profit margin under its proposed tariff, the department complained that "firm customers would be denied the full benefit of interruptible profits to which they are entitled." (*Emphasis added.*) Because interruptible rates are the result of the capacity freed by seasonally changing firm load and of the limitations placed on distributors by supply contracts, the Department reasoned that interruptible rates are themselves the result of management decisions to benefit firm customers. Therefore, it concluded, no further incentive for pursuing interruptible customers is necessary.

Most regulators presented with the issue can be expected to allow the distributor to retain some share of the profit. One alternative is to allow the utility a stated fixed return from flexible rate interruptible sales, with the balance passed to firm customers. Another alternative is to split all profits on a proportional basis. Thus, in *Pennsylvania Public Utility Commission v. Philadelphia Electric Company*, the Commission approved a proposal that the distributor, PECO, retain twenty-five percent of the gross profit from sales under the flexible rate (except for sales for boiler fuel).³² It determined that such a distribution of profit was "a sufficient incentive to encourage interruptible sales." PECO was ordered to propose a method for distributing the remaining profits to all classes of customers.

The District of Columbia Public Commission, however, decided in *Re Washington Gas Light Company* that the distributor had failed to demonstrate that its proposed twenty-five percent share was necessary to encourage flexible interruptible rate sales.³³ Instead, it awarded the utility twenty percent of the profit margin, with the remainder passed back to firm customers. Some sharing of profits was held to be justified because service to interruptible, dual fuel customers places the distributor in a position of risk.

Flexible rates also can be used to increase the risk placed on distributors. If projected sales volumes under flexible rates are included in determination of rates for firm customers, distributors may be discouraged from offering flexible rates at all. State regulators could overestimate sales under flexible rates, perhaps believing that lower rates will increase rather than merely retain sales. This would reduce rates to other customers and the distributor would bear the entire risk of any shortfall.

³¹50 P.U.R. 4th, *supra*, at 120.

³²33 P.U.R. 4th 319, 360 (Penn. P.U.C., January 4, 1980).

³³52 P.U.R. 4th 1, 73 (Wash., D.C. P.S.C., February 25, 1983).

IV. OTHER STATE RESPONSES TO DECLINING SALES

Although the most common rate design response to diminishing sales of natural gas has been the flexible rate, other innovative rate designs have been employed by distributors. They cover a broad range of experimental pricing, particularly in the industrial segment of the market. Distributors have increased their use of historical off-peak pricing techniques in the industrial market using, for example, seven month firm service rates with no service for the remaining five winter months. Moreover, a distributor could design specific rates to encourage particular end uses. Examples where specific rates could encourage gas use include residential air conditioning rates, special rates for ammonia production, special compressed natural gas rates, cogeneration rates, and special farm rates.

In several states, gas distributors with access to a limited, cheaper supply of gas have been allowed to reserve such gas for sale at low cost to dual fuel customers. Until April 30, 1983, gas made available by Michigan Wisconsin Pipeline Company under its lower, FERC-approved DR-1 rate to several distributors in Michigan and Wisconsin was offered to certain dual fuel customers at the same rate plus the distributor's usual margin.³⁴

Gas distributors in Ohio have been allowed to extend gas cost recovery adjustments, necessary because of declines in sales volumes in the previous year, to a twelve month period, instead of the customary three months. The extension is intended to avoid higher rates that might have caused dual fuel customers to switch to No. 2 oil, or which might have caused other customers to close plants. The Public Utility Commission of Ohio agreed with the distributors that higher prices could result in a loss of such customers, with the result that fixed costs would be distributed over a smaller sales volume.³⁵ At the same time, however, the Commission refused to allow Columbia Gas of Ohio to defer half of its cost adjustment for *current* costs, in order to lower gas rates, because the deferral would result in future customers paying the gas costs of current ones.³⁶

Straight discounts also could be used. In late 1981, the Connecticut Department of Public Utility Control allowed the Southern Connecticut Gas Company to adopt a five percent discount in gas prices.³⁷ It noted that the "current oil glut" had depressed the cost of oil, threatening the utility's ability to retain certain industrial customers.³⁸

There are several longer-term options which will involve a fundamental restructuring of the natural gas industry, particularly at the distributor level. While detailed descriptions of these options are beyond the scope of this article, they will be mentioned very briefly.

First, it would be possible to write-off larger industrial sales and hope to replace them with major new markets, although such a possibility is, at best, remote. The industry is more likely to see small additions to demand, which, in large part, will be offset by increasing conservation. Cogeneration is unlikely to result in major incremental use of gas because much of cogeneration will come at the expense of existing use, as major industrial users switch from buying electricity to cogeneration. The market for compressed natural gas as a motor fuel also seems to be limited.

³⁴White Paper, *supra*, at 35.

³⁵West Ohio Gas Company, Ohio P.U.C. Case No. 83-720-GA-UNC, *mimeo.* (June 1, 1983); Cincinnati Gas and Electric Company, Case No. 83-786-GA-UNC, *mimeo.* (June 15, 1983).

³⁶Columbia Gas of Ohio Company, Ohio P.U.C. Case No. 83-713-GA-UNC, *mimeo.* (June 1, 1983).

³⁷Re Southern Connecticut Gas Company, 44 P.U.R. 4th 276, 311, (Conn. Dept. of Pub. Util. Control, December 3, 1981).

³⁸*Id.* at 310.

Second, sales to certain classes of customers, including industrial users or dual fuel users, could be deregulated completely. Such deregulation would not obviate the question of how distributors would fare under these proposals. For example, although the rates for direct sales to industrial users are not regulated by the Federal Energy Regulatory Commission, the Commission remains free to allocate costs to these sales.

Third, as noted above, distributors could depart from their current practice of rolling-in prices to all customers. A distributor could dedicate its lowest cost supply of gas to its most price-sensitive customers. However, as noted *supra*, incremental pricing, for fixed or gas costs, would represent a short-term solution only. Over the long-term, each segment of a distributor's market could claim that it is an incremental market which would be lost if lower cost supplies were not dedicated to it.

Fourth, another possible solution is expansion of direct purchase programs, under which a pipeline releases shut-in or less expensive gas to industrial users, who then have gas transported by the pipeline and the distributor at normal transportation rates. This alternative produces a full contribution of fixed costs by the industrial users and delivers gas at prices which are competitive with alternate fuels.

V. FEDERAL RESPONSES

Distributors also can seek help at the federal level by encouraging their interstate pipeline suppliers to take steps to help retain industrial load. In recent months, there have been significant steps taken by interstate pipelines to retain industrial and large volumes load. Some of these responses help the distributor retain load, while others threaten to by-pass the distributor entirely. Success of these attempts is by no means established, and these programs, as do the state-level responses, avoid the longer-term question of whether industrial and large volume load can successfully be retained. Nonetheless, these programs now being used by interstate pipelines may offer short-term help to the distributor.

First, some pipelines have attempted to reduce the portion of fixed costs recovered through their commodity charges. By shifting from *United* or other traditional rate designs to variations of the modified fixed-variable rate design, the percentage of fixed costs recovered in the commodity charge can be reduced from 75% to approximately 30-40%.³⁹ This change can reduce the commodity charge by 25% or more. However, changes in rate design do not target large-volume users directly and result in shifting of costs from high load to low load factor customers. Thus, changes to those rate designs are often resisted by low load factor customers who themselves see little hope of gaining additional load. However, the concerns of low load factor customers can be met, in part, by rate designs which allocate and recover demand charges on the basis of a combined annual-peak index.

Second, pipelines have attempted to reduce their purchased gas costs generally. These efforts have included unilateral reductions in prices and take-or-pay levels,⁴⁰ deferral of recovery of purchased gas accounts,⁴¹ renegotiation of gas contracts, and the exercise of "market-out" clauses in gas purchase contracts. While renegotiation of the basic contractual structure in the natural gas industry may be the only long-term solution to today's problems, these efforts do not target large volume users directly. Hence, their incremental value in the short-term may be limited.

³⁹*E.g.*, Natural Gas Pipeline Company of America, 23 F.E.R.C. ¶ 63,032 (1983).

⁴⁰*E.g.*, Complaint of Tennessee Gas Pipeline Co., Docket No. RP83-109-000 (filed July 14, 1983).

⁴¹*E.g.*, Panhandle Eastern Pipe Line Co., Docket No. TA83-2-28, 23 F.E.R.C. ¶ 61,319 (1983).

Third, some pipelines have specifically sought to shift fixed cost responsibility from industrial users, alleging that otherwise these users would be lost from the system. Under this theory, any contribution by these customers to fixed costs should be accepted because the alternative is to have no contribution made by these customers at all. Northern Natural Gas Company was one of the first pipelines to implement such programs. Northern offers two programs to its customers.⁴² Under the first, Northern reduces the fixed cost recovered from large-volume users provided the distributor receives state approval to flow through the reduced rates directly to large-volume users. Under its second alternative, a distributor contracts directly with a large-volume user, and Northern reduces its margin for such sales by matching the reduction which the distributor makes in its margin. Programs like these directly focus on competition for alternative fuels.

Fourth, some pipelines have initiated programs under which they release portions of their contracted-for supplies and sell them directly to industrial users.⁴³ Under these programs, end-users nominate a price level and the pipeline offers this price, less transportation, to producers whose supplies otherwise would be shut-in. This enables producers to increase their sales, end-users to control their gas costs, and pipelines to reduce their take-or-pay obligations. This shift from an "add-on system" of gas pricing to netback pricing may represent the most hopeful long-term response if it could be extended for release programs to direct pipeline purchases.⁴⁴

Two other options are, of course, available although they have not yet been tried on a large scale basis yet. First, a pipeline could deviate from rolled-in pricing and assign gas costs directly to individual users on the basis of their market-clearing prices. While the gas release programs discussed above achieve this result indirectly, pipeline moves to achieve this directly have been limited. Because rolled-in pricing has a long tradition, it is unlikely that any major pipeline will take this step in the immediate future. Furthermore, some industrial groups could be expected to oppose any such move because a departure from rolled-in pricing which results in lower costs today also could produce higher rates for industrials in the future if oil prices firm up.

Second, industrials could purchase gas directly and forego purchases from pipelines and end-users. While the Federal Energy Regulatory Commission has approved programs which make it easier for end-users to obtain direct transportation of gas,⁴⁵ the programs are not mandatory. Legislation now pending in Congress would make contract carriage mandatory for pipelines and distributors. Industrial users' use of these programs may be tempered by a concern that direct purchase volumes will be excluded from future pipeline curtailment plans.

⁴²Northern Natural Gas Company, Docket No. CP83-14-000, 21 F.E.R.C. ¶ 61,324 (1982), 22 F.E.R.C. ¶ 61,173 (1983), 23 F.E.R.C. ¶ 61,295 (1983). Northern is proceeding under a temporary certificate, and its program has been the subject of a formal hearing at the Commission.

⁴³*E.g.*, Transcontinental Gas Pipe Line Corp., 23 F.E.R.C. ¶ 61,199 (1983); Application of Tennessee Gas Pipeline Company, Docket No. CP83-502-000 (filed September 8, 1983).

⁴⁴In the current system of add-on pricing, burner tip prices are established by adding transportation and distribution charges to predetermined wellhead price is established by subtracting transportation and distribution charges from a burner tip price set at market-clearing levels. While net back policies have been instituted for sales of "released" gas, interstate pipelines have not yet implemented for all sales. *See n. 43 supra*. However, a producer group has, for the first time, filed such a program at the Federal Energy Regulatory Commission, Application of Tenneco Oil Company, Docket No. C183-269-000 (filed June 17, 1983).

⁴⁵Interstate Pipeline Blanket Certificates for Routine Transactions and Sales and Transportations by Interstate Pipelines and Distributors, 48 Fed. Reg. 34,872 (1983); Sales and Transportation by Interstate Pipelines and Distributors, 48 Fed. Reg. 34,875 (1983).

V. CONCLUSION

At best, flexible rates are a short-term option which may be available to an industry that badly needs to retain its customers. These rates are not a cure for the current market malaise. Any proposed solutions to the current marketing situations must not be so narrowly drawn as to destroy the ability to respond quickly if conditions change. The emphasis on immediate resolution to current problems should not detract attention and energy from treating a larger problem: that present regulatory procedures and delays are a barrier to competitive responsiveness. The major goal for regulators and utilities alike should be to develop flexibility, not merely flexible rates.