

SUBMITTED COMMITTEE REPORTS

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REPORT OF THE COMMITTEE ON NATURAL GAS REGULATION*

I. CERTIFICATE ISSUES

In Docket No. RM98-9-000, the Federal Energy Regulatory Commission (FERC or Commission) issued a Notice of Proposed Rulemaking (NOPR) proposing to streamline its pipeline certificate regulations by expanding its blanket certificates to allow pipelines to construct and operate more facilities than are currently covered; changing its regulations to facilitate receipt point construction; and allowing pipelines, under a blanket certificate, to construct and operate temporary compression stations.¹ The proposed rule would also create more manageable and informative environmental filing requirements.

The FERC issued a separate NOPR that introduced a collaborative process to assist pipelines in resolving significant issues before filing an application to construct facilities.² The NOPR's objective is to improve communication, increase public participation, and resolve potential conflicts early on. The proposed rule would instruct applicants to notify the FERC and the general public, including landowners and state and local government officials, of its intention to initiate a pre-filing consultation. The approach allows the applicant to work with the FERC's staff and other interested parties to complete environmental studies before filing an application.

II. GAS INDUSTRY STANDARDS BOARD

Order No. 587-G

In Order Nos. 587, 587-B, and 587-C, the Commission adopted regulations to standardize the business practices and communication methodologies of interstate pipelines to create a more efficient and integrated pipeline grid.³ In Order No. 587-G,⁴ the FERC required pipelines to accord an intra-day nomination submitted by a firm shipper scheduling priority over nominated and scheduled volumes for

* The Committee would like to express special thanks to Brian Corcoran, Member at Oliver & Oliver, P.C., and Gabriel Calvo and Kathryn Ogas, Law Clerks at McCarthy, Sweeney & Harkaway, P.C., for their assistance in preparing this report.

1. Notice of Proposed Rulemaking, *Revision of Existing Regulations Under Part 157 and Related Sections of the Commission's Regulations Under the Natural Gas Act*, F.E.R.C. STAT. & REGS. ¶ 32,535, 63 Fed. Reg. 55,683 (1998).

2. Notice of Proposed Rulemaking, *Collaborative Procedures for Energy Facility Applications*, F.E.R.C. STAT. & REGS. ¶ 32,536, 63 Fed. Reg. 53,853 (1998).

3. Order No. 587-C, 18 C.F.R. § 284.10 (1997); Order No. 587-B, 18 C.F.R. § 284.10 (1997); Order No. 587, 18 C.F.R. § 284.10 (1996).

4. Order No. 587-G, *Standards for Business Practices of Interstate Natural Gas Pipelines*, III F.E.R.C. STAT. & REGS. ¶ 31,067, 63 Fed. Reg. 53,565 (1998) (to be codified at C.F.R. pt. 284) *on reh'g*; Order No. 587-G, *Standards for Business Practices of Interstate Natural Gas Pipelines*, III F.E.R.C. STAT. & REGS. ¶ 31,062, 63 Fed. Reg. 20,072 (1998) (to be codified at C.F.R. pt. 284), *order on reh'g*.

interruptible shippers. The Commission, however, deferred implementation of this requirement until the Gas Industry Standards Board (GISB) had developed, and the Commission had adopted, standards to implement the regulation. Order No. 587-G will create the uniform process shippers need to coordinate their intra-day nominations across the pipeline grid. The standards governing nomination and confirmation procedures should help create a more reliable nomination process in which pipelines will receive accurate information, so they can schedule nominations and intra-day nominations that their systems can accommodate. Perhaps the rule's most prominent provision gives firm intra-day nominations priority over already nominated and scheduled interruptible transportation service. It also requires pipelines to permit firm intra-day nominations submitted on the day prior to gas flow to go into effect at 9 a.m. the following day. The order provides that by June 1, 1999, pipelines must provide all information and conduct all business using the public Internet and standardized protocols.

III. GAS RESEARCH INSTITUTE

The natural gas industry reached a final agreement on a permanent funding mechanism for the Gas Research Institutes's (GRI) research, development and demonstration programs. The agreement calls for collection of more than \$700 million in surcharges from 1998 to 2004, a phase-out of annual funding followed by voluntary funding, and a requirement that nearly all pipelines remain GRI members during the seven-year period.⁵ The GRI's 1999 budget, which is the first to incorporate core and noncore programs, is consistent with the settlement. The budget, which was approved by the FERC, includes \$77.1 million for 42 core research projects considered widely beneficial to the entire gas industry and consumers and \$54.9 million for 28 projects aimed at specific activities and market segments.

IV. MARKETING AFFILIATE RULES

Procedural Matters

The FERC ruled that the Natural Gas Pipeline Company of America (Natural) committed significant violations of the FERC's marketing affiliate rules and other regulations arising out of a complaint by Amoco Production Company and Amoco Energy Trading Corporation charging Natural with "systematic favoritism" with respect to MidCon Gas Service Corporation, Natural's affiliated gas marketer.⁶ The FERC assessed civil penalties against Natural at a rate of \$5,000 per violation per day for a total penalty of \$8,840,000 but suspended one half of the fine provided that Natural does not violate Standards E, F, G or K, or section 250.16(b)(1) of the Commission's regulations during the next two years.

5. Final Report of the Chief Judge and Certification of Settlement, *Gas Research Inst.*, 82 F.E.R.C. ¶ 63,014 (1998).

6. *Amoco Prod. Co. and Amoco Energy Trading Co. v. Natural Gas Pipeline Co. of Am.*, 82 F.E.R.C. ¶ 61,038 (1998).

V. ORDER 636 AND RESTRUCTURING MATTERS

The FERC proposed revisions to its regulations governing interstate natural gas pipelines that reflect the market changes for short-term transportation services on pipelines.⁷ The NOPR provides for the elimination of cost-based regulation for short-term transportation and replaces it with regulatory policies aimed at maximizing competition in the short-term transportation market, reducing the exercise of residual monopoly power, and providing greater flexibility in the provision of pipeline services. The NOPR revises pipeline nomination and scheduling procedures and flexible receipt and delivery point policies to allow capacity release to compete with pipeline capacity. To limit the exercise of market power and the potential for discrimination, the NOPR proposes to require that all short-term capacity be sold through capacity auctions. The NOPR also proposes changes to the FERC's reporting requirements to improve the ability of shippers and the FERC to monitor the marketplace. The NOPR also is intended to improve competition across the pipeline grid, foster greater innovation in pipeline services, and create a more efficient marketplace.

In Docket RM98-12-000, the FERC issued a Notice of Inquiry (NOI) seeking comments on its pricing policies in the existing long-term market and pricing policies for new capacity. The FERC felt its policies may need to be reconsidered in light of the increasingly competitive natural gas industry.⁸ One of the FERC's objectives in the review undertaken in the NOI is to assure that its policies do not provide an artificial disincentive to long-term contracts but are neutral with regard to long-term and short-term contracts.

VI. RATES

The major rate decisions during 1998 focused on return on equity and capital structure issues.⁹ On July 29, 1998, in its order on rehearing in the *Transcontinental Gas Pipe Line Corp.*,¹⁰ the FERC issued Opinion No. 414-A, modifying its 1997 formula for analyzing return on equity and capital structure issues.

In 1997, the FERC issued Opinion No. 414¹¹ which modified its then-current capital structure analysis.¹² Opinion No. 414 also adopted a modified *Kentucky West* analysis.¹³ Under this modified analysis, the FERC would utilize the applicant's own capital structure for ratemaking purposes if the applicant's equity ratio fell within the range of equity ratios for the proxy companies. The FERC also

7. Notice of Proposed Rulemaking, *Regulation of Short-Term Natural Gas Transportation Services*, F.E.R.C. STAT & REGS. ¶ 32,533, 63 Fed. Reg. 42,982 (1998) [hereinafter *Aug. 11 NOPR*].

8. Order Granting Extension of Time for Filing Comments, *Regulation of Short-Term Natural Gas Transportation Services*, 85 F.E.R.C. ¶ 61,431 (1998).

9. See, e.g., Order Granting Rehearing in Part, *Williams Natural Gas Co.*, 84 F.E.R.C. ¶ 61,080 (1998).

10. Opinion No. 414-A, *Transcontinental Gas Pipe Line Corp.*, 84 F.E.R.C. ¶ 61,084 (1998).

11. Opinion No. 414, *Transcontinental Gas Pipe Line Corp.*, 80 F.E.R.C. ¶ 61,157 (1997).

12. Opinion No. 7, *Kentucky West Va. Gas Co.*, 2 F.E.R.C. ¶ 61,139 (1978).

13. However, the Commission held in *Kentucky West* that it would use an alternative if (1) the pipeline's financing is controlled by another entity, such as a corporate parent, or (2) the pipeline's actual capital structure does not reasonably reflect its operating risk. *Id.* at 61,325-28.

modified its Return On Equity (ROE) policies in Opinion No. 414 holding that it would utilize the two-step Discounted Cash Flow (DCF) methodology, as modified by Opinion No. 396-B,¹⁴ to determine the ROE.

A. Capital Structure

On rehearing, the FERC concluded that its current capital structure analysis, as adopted in Opinion No. 414, did not provide sufficient flexibility. Thus, in order to permit evaluation of individual pipeline circumstances, the FERC now will utilize an applicant's own capital structure, provided the applicant issues its own non-guaranteed debt and has its own bond rating. The FERC will also compare the applicant's capital structure with those of other Commission-approved pipelines and with proxy companies. In cases where such comparison reveals that an applicant's equity ratio is so far outside the range of other equity ratios approved by the FERC and the range of proxy company equity ratios that it is unreasonable, the FERC will utilize an imputed capital structure (typically that of the corporate parent). However, the FERC has determined that it will not continue to require that a pipeline's equity ratio be within the range established by the proxy companies in order to use the pipeline's own capital structure. The FERC has concluded that this requirement is too stringent and could hamper its ability to establish an appropriate capital structure in some cases.

B. Return on Equity

The FERC renewed its commitment to a two-step DCF analysis of growth that calculates a short-term growth projection and averages it with a separately determined long-term growth projection. The FERC stated that it would follow the methodology adopted in Opinion No. 396-B and would choose the allowed ROE from the highest, middle, or lowest points of the range of the proxy group.¹⁵

Although the FERC maintained the two-step DCF analysis adopted in Opinion No. 414, it now will give short-term growth a two-thirds weighting (given the greater reliability of short-term projections) and long-term growth a one-third weighting. The FERC will continue to give some effect to long-term growth projections because of their usefulness in normalizing any distortions that might be reflected in short-term data limited to a narrow segment of the economy. The Commission will continue to use Institutional Brokers Estimate System (IBES) data for short-term growth projections and GDP data for long-term growth projections.

VII. NEGOTIATED TERMS AND CONDITIONS OF SERVICE

In January 1996, the Commission issued its Statement of Policy and Request for Comments which, in addition to announcing guidelines applicable to negotiated rates, declined to permit the negotiation of individual shipper terms and conditions of service.¹⁶ Citing a need to consider more fully the legal and policy implications

14. Opinion No. 396-B, *Northwest Pipeline Corp.*, 79 F.E.R.C. ¶ 61, 309, *reh'g denied*, Opinion No. 396-C, *Northwest Pipeline Co.*, 81 F.E.R.C. ¶ 61, 036 (1997).

15. *Id.* at 61,671-73.

16. Statement of Policy and Request for Comments, *Alternatives to Traditional Cost-of-Service Ratemaking*

of negotiated terms and conditions of service, the Commission established a separate proceeding to consider these issues.¹⁷

In May 1998, Northern Natural Gas Company (Northern) proposed to implement, on a prospective basis, tariff sheets which would permit shippers to negotiate limited terms and conditions of service, including *inter alia*: hourly takes, options to acquire firm capacity, non-performance clauses, shipper "opt-out" clauses, and right of first refusal terms. In its suspension order, the Commission set these pro forma proposals for hearing.¹⁸ In June 1998, Columbia Gas Transmission Corporation (Columbia Gas) and Columbia Gulf Transmission Corporation (Columbia Gulf), Docket Nos. RP98-249 and RP98-250, respectively, filed pro forma tariff sheets to permit negotiation of tariffed services. No action has been taken in these proceedings to date.

Subsequent to the filings by Northern, Columbia Gas, and Columbia Gulf, the Commission issued a Notice of Proposed Rulemaking, on July 29, 1998, proposing, among other things, to give pipelines more flexibility in negotiating rates and terms and conditions of service.¹⁹ To that end, the FERC proposed to permit negotiated rates, terms, and conditions of service pursuant to guiding principles designed to protect recourse customers, to prevent undue discrimination and preference, and to foster competition in interstate capacity markets. The FERC seeks comments on whether it should permit the negotiation of services in the short-term markets. The Commission also invites comments, currently due April 22, 1999, on virtually all aspects of the proposed rulemaking.

As outlined in the NOPR, the negotiation of any rate, term, or condition of service for transportation services would be subject to a number of guiding principles.²⁰

A. Guiding Principles

1. No Undue Discrimination or Preference

Since by their nature negotiated rates and services distinguish among customers, the Commission voiced particular concern that such rates and services should not violate the prohibition against undue discrimination and preference. While acknowledging that the existing undue discrimination standards apply to "similarly situated" shippers, the Commission recognized that the standard applicable to negotiated rates and services may need to be established before meaningful negotiations can occur. Such a standard, if available, would provide guidance to the parties concerning acceptable conduct, and provide an effective

for *Natural Gas Pipelines*, and *Regulation of Negotiated Transportation Services of Natural Gas Pipelines*, 74 F.E.R.C. ¶ 61,076 (1996), *clarification granted*, 74 F.E.R.C. ¶ 61,194 (1996), *reh'g denied*, 75 F.E.R.C. ¶ 61,024 (1996), *reh'g denied*, 75 F.E.R.C. ¶ 61,066 (1996); *petition for review dismissed without prejudice*, *United Distribution Co. v. FERC*, 1997 WL 150071 (D.C. Cir. 1997).

17. *Id.* at 61,225, 61,242.

18. *Northern Natural Gas Co.*, 83 F.E.R.C. ¶ 61,216 (1998), *reh'g denied*, 84 F.E.R.C. ¶ 61,281 (1998).

19. *Aug. 11 NOPR*, *supra* note 7, at 33, 430.

20. In addition, the FERC indicated it would conduct a generic review of the negotiated services after they had been in effect for two heating seasons. *Id.* at 33,474 (mimeo at 119).

monitoring and enforcement tool. The Commission, however, recognized that a generic standard may be difficult to craft since findings of undue discrimination generally depend on specific facts. Thus, the Commission requested comments on the desirability and feasibility of developing standards to govern undue discrimination and preference before negotiations begin.²¹

2. No Degradation of the Quality of Service

Because of a concern by and for captive customers, the Commission proposes to permit negotiated rates and services provided that the quality of service for recourse customers is undiminished.²²

3. No Impairment of the Tradability of Capacity

The Commission expressed concern that negotiated rates and services could adversely affect competition in capacity markets. To diminish this possibility, the Commission proposed that negotiated rates and services be permitted only if such negotiation does not impair tradability of capacity, cause a significantly greater concentration of sellers in capacity markets, or significantly reduce existing competition. Notwithstanding these restrictions, the Commission remained hopeful that innovations may lead to negotiated services that do not impair the tradability of capacity.²³

4. No Unwanted Tying Arrangements

Driven by a concern over market power, the Commission proposed that a pipeline may not require a negotiated service to be tied to any unwanted service provided by the pipeline, its affiliate, or an upstream pipeline, except if necessary to provide the negotiated transportation service. The Commission cited storage service as a possible prerequisite to the pipeline's ability to provide negotiated transportation service.²⁴

5. Transparency of Negotiated Transactions

Noting that full disclosure of the terms of negotiated transactions was critical to the Commission's and the shippers' ability to uncover undue discrimination and preference, the Commission proposed to require that the essential elements of such transactions, including price, be transparent to the public and the Commission. Accordingly, the Commission proposed that pipelines be required to file written notice with the Commission and serve on all firm shippers the essential information of the negotiated transaction prior to its becoming effective.²⁵

21. *Aug. 11 NOPR, supra note 7, at 33,474-75.*

22. *Id.* at 33,475.

23. *Aug. 11 NOPR, supra note 7, at 33, 475-76.*

24. *Id.* at 33,476.

25. *Aug. 11 NOPR, supra note 7, at 33,476.*

B. Implementation of Negotiated Rates and Services

While acknowledging that negotiated transactions may have an adverse impact on competitive markets and recourse shippers, the Commission found that risk to be manageable and, to that end, proposed a method for implementing negotiated services, including the following.

1. Procedural Mechanism

The Commission proposed that pipelines interested in negotiating terms and conditions of service should be required to submit an initial filing seeking authority to negotiate rates and services. This filing would serve to define and establish "high quality" recourse service.²⁶ In addition, the filing would identify categories of non-negotiable, negotiable, and potentially negotiable terms and conditions of service.²⁷ Interested parties would have an opportunity to comment on the pipeline's filing. Only after the Commission approved the filing would the pipeline be permitted to begin negotiations.

With regard to the negotiable category of terms and conditions, the Commission proposed to permit such services to become effective following a 10-day notice period without further Commission action. The Commission requested comments on the duration, if any, of the advance notice period.

2. Recourse Service

Recourse service would be available to all shippers. Expressing concern that such service should maintain high quality, the Commission proposed procedures for assuring its good quality, initially and over time. Any pipeline seeking to implement negotiated services must, at the time of that filing, also define the components of its recourse rates. Reiterating that recourse service must be of a high quality and reliability, the Commission also indicated that such service must maintain at least the level of service currently being offered by the pipeline.²⁸ In short, the *quid pro quo* for a pipeline desiring to offer negotiated services is the establishment of adequate recourse service.

In addition to its concerns over procedures to implement initial recourse service, the Commission also proposed procedures for periodic reviews, *e.g.* every three-to-five years, to ensure the long-term viability of recourse service.

3. The Release of Negotiated Capacity

To enhance the tradability of capacity, the Commission is considering allowing, but not requiring, a negotiated service to revert to recourse service when it is offered for release. Pipelines would be required to include such a provision in their tariffs.²⁹

26. *Id.* at 33,477.

27. The Commission indicated that it would carefully examine the proposed categories, particularly the negotiable category. Terms in the non-negotiable category, as the name suggests, could never be negotiated. *Aug. 11 NOPR, supra* note 7, at 33,477.

28. *Id.* at 33,479.

29. *Aug. 11 NOPR, supra* note 7, at 33,481.

4. Negotiations of Rates and Services with Affiliates

Under the Commission's proposal, pipelines would be permitted to enter into negotiated transactions with their affiliates, provided that all similarly situated shippers are offered the same rates and services. As it has done previously, the Commission would employ a rebuttable presumption that all shippers receiving the same type of service, and using the same pipeline facilities, are similarly situated.³⁰

5. Negotiation of Capacity Release and Flexible Point Rights

Expressing its concern that negotiated transactions may adversely affect competition due to relinquishment of capacity release and flexible points rights, the Commission sought comments on whether those rights should be non-negotiable.³¹

6. Future Cost Allocation Issues

The Commission recognizes that negotiated rates and services may have an adverse impact on recourse shippers. On the other hand, the Commission is concerned that if pipelines are barred from discount-type adjustments for negotiated transactions, they may be disinclined to use negotiated transactions. Hence, the Commission is considering examining all rate issues related to negotiated rates and services in future rate cases, including, for example, revenue shortfalls and excess revenues.³²

7. Reporting, Monitoring, and Complaint Procedures

To enhance both the Commission's ability and the shippers' ability to detect and deter abuses of market power, the Commission proposed that pipelines be required to report, in the Index of Customers, each contract that contains negotiated rates and services. The additional information is designed to uncover the existence of similarly situated shippers and any affiliation between the capacity holder and the shipper. Further, to assure compliance with the guidelines, the Commission proposes to actively monitor the pipelines' compliance efforts through audits or special studies.³³

NATURAL GAS REGULATION COMMITTEE

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30. *Aug. 11 NOPR, supra note 7, at 33,481-82.*

31. *Id.* at 33,482.

32. *Aug. 11 NOPR, supra note 7, at 33,482-83.*

33. *Id.* at 33,483-84. In addition, the Commission indicated that to stem abuses an effective complaint process would be necessary, a matter which the Commission is considering in a separate NOPR. See Notice of Proposed Rulemaking, *Complaint Procedures*, F.E.R.C. STAT. & REGS. ¶ 61,082, 63 Fed. Reg. 41,982 (1998).

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