

RESTRUCTURING THE NATURAL GAS INDUSTRY: ORDER NO. 436 AND OTHER REGULATORY INITIATIVES

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The Federal Energy Regulatory Commission (FERC) issued on October 9, 1985, its new rules on transportation, take-or-pay and expedited certificates in Order No. 436.¹ Two months later, the Commission modified the new rules in Order No. 436-A.² The FERC rulemaking is a response to industry changes caused by the removal of wellhead price controls on certain categories of natural gas that occurred on January 1, 1985 and to distortions in the natural gas market that became pronounced in the early 1980s. With the lifting of price controls and adoption of the Commission's new regulations, the natural gas industry is being restructured in very significant ways. It is the purpose of this paper to provide an overview of the changes wrought by Order No. 436 and by other recent FERC regulatory actions.

Order No. 436 was issued in Docket No. RM 85-1, a regulatory initiative commenced on December 24, 1984 with a Notice of Proposed Rulemaking (NOPR).³ The Commission declared that it was instituting a series of inquiries into the effects on the natural gas industry of the transition to competitive pricing of natural gas,⁴ and solicited comments on the interstate transportation of natural gas on behalf of shippers who do not own pipelines. A second NOPR issued in Docket No. RM 85-1 on January 18, 1985 sought comments on ratemaking and the allocation of financial risks, including rolled-in pricing of gas, spot market sales, take-or-pay contract provisions, risk of market loss, minimum bills and rate of return on capital.⁵ All segments of the natural gas industry responded to the NOPRs with voluminous comments. Oral presentations were entertained, and, having digested the record it had solicited, FERC issued

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1. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 42,408 (Oct. 18, 1985), [hereinafter cited as Order No. 436] *modified*, Order No. 436-A, 50 Fed. Reg. 52, 217 (Dec. 23, 1985), *modified*, Order No. 436-B, 51 Fed. Reg. 6398 (Feb. 24, 1986), *appeal filed sub nom.* Maryland People's Counsel v. FERC, No. 85-1813 (D.C. Cir. Dec. 12, 1985).

2. Order No. 436-A, *supra* note 1.

3. Interstate Transportation of Gas for Others, 50 Fed. Reg. 114 (January 2, 1985).

4. Under the Natural Gas Policy Act (NGPA), 15 U.S.C. §§ 3301-3432 (1982), decontrol of the wellhead price of natural gas is phased, with the intent of gradually substituting market forces for regulation to control the allocation of natural gas. See Order No. 406, 49 Fed. Reg. 46,874, 46,875 (Nov. 29, 1984); Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345 at 348-49 (1983). On January 1, 1985, price controls on various categories of "new" natural gas were lifted by section 121 of the NGPA. 15 U.S.C. § 3331 (1982).

5. Natural Gas Pipeline Ratemaking, Risk and Financial Implications After Partial Wellhead Decontrol, 50 Fed. Reg. 3081 (January 28, 1985).

Order No. 436. Order Nos. 436-A and 436-B were issued to respond to applications for rehearing, modification or clarification filed by virtually every participant in the rulemaking.⁶

Order No. 436 is the latest in a series of major regulatory initiatives undertaken by the Commission in actions that have impacted gas pricing, pipeline contracting provisions (take-or-pay and minimum bills), spot market sales, and transportation. The policy followed by the Commission reflects a profound faith in the free market to achieve the objective of efficient resource allocation at reasonable cost to consumers.⁷

I. GAS PRICING

Reflecting Administration policy in the early 1980s, the FERC undertook steps to deregulate as much natural gas as allowable under the NGPA and to increase regulated prices to market clearing levels. In recent years, Commission policy has been to deregulate gas costs to the extent permissible by the NGPA.

Under section 107 of the NGPA, FERC has the authority to increase the price of high cost gas where it is necessary to provide an incentive to develop gas supplies which would not otherwise be developed because of the extraordinary risks or costs involved.⁸ In April of 1980, FERC issued Order No. 78 deregulating four categories of high cost gas listed in Section 107(c): gas from geopressurized brine, occluded gas from coal seams, gas produced from below 15,000 ft, and gas from Devonian shale.⁹ In Order No. 99, issued August 15, 1980,¹⁰ FERC defined gas from tight formations as high risk gas, and by October 1985, the Commission had classified 192 specific formations as tight formations.¹¹ FERC has continued to publish a special incentive price for tight formation gas, while other categories of high cost gas were deregulated as of November 1, 1979.¹²

Under Sections 104 and 106 of the NGPA, FERC is granted authority to establish new just and reasonable prices for old natural gas dedicated to interstate commerce.¹³ FERC, in 1982, abandoned a proposed rulemaking to do just that (RM 82-26)¹⁴ in the face of strong Congressional opposition.¹⁵ FERC must now revisit this issue. The Commission has informally indicated it will observe the effects of partial decontrol and then will consider submitting legislation to Congress that would deregulate all gas not deregulated on January 1,

6. Lists of applicants for rehearing and petitioners for clarification may be found in Order 436-A, app. A & B; 50 Fed. Reg. 52,217 (1985).

7. At least to some extent, this policy is based on the mandate of the NGPA to substitute market forces for regulation of the cost of gas. See *supra* note 4; see also *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Board of Miss.*, 54 U.S.L.W. 4114 (U.S. Jan. 22, 1985).

8. 15 U.S.C. § 3317(b) (1982).

9. 45 Fed. Reg. 28,092 (April 28, 1980), *reh'g denied*, 11 F.E.R.C. ¶ 61,299 (1980).

10. 45 Fed. Reg. 56,034 (Aug. 22, 1980).

11. See, e.g., *High Cost Gas Produced from Tight Formation*; Wyoming, 50 Fed. Reg. 40,361 (1985) (to be codified in 18 C.F.R. § 271.703 (d) (191)).

12. See 18 C.F.R. § 271.101, Subpart G (1985).

13. 15 U.S.C. §§ 3314 (b)(2), 3316(c) (1982).

14. 47 Fed. Reg. 19,157 (May 4, 1982).

15. See S. Res. 331, 97th Cong., 2d Sess. (1982).

1985.¹⁶ But the Administration has not waited for FERC to act. The Department of Energy in November of 1985 proposed rules to deregulate old natural gas under the authority conferred by Section 106 of the NGPA.¹⁷ The Commission has the jurisdiction to decide whether to adopt the proposal and has indicated that it will respond by June 1, 1986.¹⁸

On November 16, 1984, the FERC issued Order No. 406, which established procedures for partial price deregulation on January 1, 1985.¹⁹ The Commission indicated that it already had in place administrative procedures under Section 503²⁰ of the NGPA for determining various categories of gas. Just as a determination under Section 503 of the NGPA is required in order to qualify gas as high-cost section 107 gas, determinations are required to qualify for the newly deregulated Sections 102(c), 103, 105 and 106(b).²¹ Order No. 406 states that, if a producer has previously obtained a section 102(c) or section 103 determination, he need not have that gas redetermined. Prior to receiving a final determination under section 503, gas which qualifies for a deregulated price may not be sold as deregulated gas.

Order No. 406 addresses the important issue of dually-qualified gas. The problem arises in contracts which tie the contract price to the maximum NGPA price. Examples of categories of dually qualified gas are tight formation gas (Section 107(c)(5)),²² and stripper well gas (Section 108),²³ the production wells for which were completed after 1977.²⁴ Both of these categories of gas may qualify for deregulation under Sections 102 and 103. The Commission noted that, as of November 16, 1983, market prices were lower than sections 102 and 103 ceiling prices and well below sections 107 and 108 prices. Reasoning that Congress intended to substitute market prices for price controls on January 1, 1985, the Commission ruled that Section 121 requires deregulation of gas that is dually-qualified. Hence, in contracts providing alternative treatment for dually-qualified gas, those provisions relating to unregulated prices for dually qualified gas apply, even though the result is a significant lowering in the contract price of gas.

Regarding intrastate contract gas, the Commission ruled that Section 121 of the NGPA deregulates "the whole universe of section 105 gas," and Section 105(b)(3) re-regulates section 105 gas, the price of which was in excess of \$1.00 per MMBtu on December 31, 1984 solely because of the effect of an indefinite price escalator. The Commission construed this provision narrowly to give the broadest application to the deregulation mandate. Intrastate gas subject to existing, successor or rollover contracts is deregulated if the December 31,

16. See *INSIDE FERC* (McGraw-Hill) at 3 (Jan. 7, 1985).

17. 50 Fed. Reg. 48,540 (Nov. 25, 1985).

18. *Id.* at 48,546. See also, *INSIDE FERC* (McGraw-Hill) 1, 8 (Nov. 25, 1985).

19. Deregulation and Other Pricing Changes on January 1, 1985, under the Natural Gas Policy Act, 49 Fed. Reg. 46,874 (1984) [hereinafter cited as Order No. 406].

20. 15 U.S.C. §§ 3413(a), 3413(b) (1982).

21. 15 U.S.C. §§ 3312(c), 3313, 3315, 3316(b) (1982)

22. 15 U.S.C. § 3317(c)(5) (1982).

23. 15 U.S.C. § 3318 (1982).

24. Approximately 40% of new tight formation wells are not deregulated because they are above the 5,000 foot depth requirement for section 103 deregulation. See Order No. 406-B, 30 F.E.R.C. ¶ 61,152 at 61,322 (1985).

1984 price under any pricing clause exceeded \$1.00 per MMBtu. However, if an indefinite price escalator clause is the sole reason for the price being in excess of \$1.00 per MMBtu, then a new regulated price applies according to a formula set out in Section 105(b)(3)(A).²⁵

Related to the price of gas is the issue of rate structure for rates charged by interstate pipelines. In Docket No. RM 85-1, the Commission proposed new ratemaking treatment for purchased gas costs which would have established three separate rate blocks.²⁶ The first block, containing regulated gas under sections 104, 106(a) and 109²⁷ of the NGPA, would have been reserved for firm sales customers of the pipelines. The second block would have contained all other gas and would have been billed to non-system customers. The third block, containing non-gas costs associated with purchasing gas, would have been allocated among blocks one and two. The three block proposal met widespread opposition, and in Order No. 436, FERC declined to adopt a final rule and instead proposed a new two-block system with features similar to the earlier proposal: elimination of rolled-in pricing and reservation of regulated gas for the pipeline's system customers.²⁸ The new proposal would phase in block billing beginning in the summer of 1986 and expand the base period from which user entitlements are to be measured. A final rule on this issue has not yet been adopted.

Order No. 436 took action to free up the supply of shut-in gas. Supplies of some higher priced gas (Sections 102(d) and 108) and old interstate gas (Sections 104 and 106(a)) have been shut-in by pipelines due to take-or-pay penalties applicable to other sources. Producers have been unable to market these supplies due to existing interstate certificates for their gas supplies.²⁹ Order No. 436 directs Commission staff to expedite all applications for abandonment of shut-in gas so that a decision can be reached prior to March 1, 1986.³⁰ Although not strictly a pricing action, the ruling should increase the amount of lower cost gas committed to the spot market, and thereby exert a downward pressure on prices.

The purpose of FERC's actions on gas pricing is to "unbundle" the costs of natural gas from other costs charged to consumers through gas rates—specifically, the fixed costs attributable to investment in facilities, operation and maintenance, transportation, and return on invested capital. FERC has concluded that only by unbundling gas costs from other rate components can price signals be transmitted effectively from burner-tip to the wellhead. With effective transmission of price signals, the market should control the price of gas and achieve an efficient balance between supply and demand.³¹

One purpose of regulation is to avoid or to dampen out drastic swings in

25. See Order No. 406-A, 49 Fed. Reg. 50,637 at 50,640-41 (1984).

26. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 24,130 (June 7, 1985).

27. 15 U.S.C. §§ 3314, 3316(a), 3319 (1982).

28. Order No. 436, *supra* note 1, at 42,410-11.

29. Once committed to interstate commerce, a particular gas source cannot be abandoned absent Commission approval. 15 U.S.C. § 717f(b) (1982).

30. Order No. 436, *supra* note 1, at 42,467.

31. *Id.* at 42,413, 42,422-23.

supply and demand that occur in open markets. The natural gas industry has suffered drastic supply and demand swings despite pervasive regulation. The Commission deserves credit for responding to these difficulties, yet it remains to be seen whether "unbundling" will foster the efficient allocation of supplies to meet demand and provide stability in the industry. While the recent decline in gas prices has been a tonic for consumers, many independent producers have gone bankrupt.³² Proven reserves have declined steadily, and exploration activity has been extremely sparse.³³ Trends may turn around once supply has dropped sufficiently to force prices to rise, but another swing of the pendulum would hardly be cause for celebration. There is the possibility that FERC's goal of producing an open commodity market for gas will be successful; but it is also possible that the public interest will suffer owing to large swings in gas prices.³⁴

II. PIPELINE CONTRACTING PROVISIONS

Recognizing that the contracting practices of natural gas pipelines have contributed to market rigidity and unresponsive price signals, the Commission has changed its regulatory approach to contracting practices. The ruling regarding dually qualified gas, described above, prevents contracts from blocking the deregulation of certain categories of gas. In addition, take-or-pay clauses have come under scrutiny by the Commission, and minimum bill provisions have, to a large degree, been voided.

On December 16, 1982, FERC issued a policy statement that, in future rate cases, would apply prospectively a rebuttable presumption that take-or-pay obligations in excess of seventy-five percent of contract amounts would be excluded from the cost of service for regulated pipelines.³⁵ The Commission limited this policy to contracts entered into after December 16, 1982.³⁶

On April 10, 1985, the Commission adopted a new rule, 18 C.F.R. § 2.76, establishing Commission policy on rate treatment of take-or-pay payments.³⁷ Prior practice was changed, in that payments may no longer be passed on automatically through the purchased gas adjustment clause. Any take-or-pay payments made by a pipeline may be recovered only in a general rate increase proceeding under Section 4 of the Natural Gas Act, where recovery of the amounts is subject to challenge on the grounds of prudence.³⁸

On May 25, 1984, FERC adopted a new minimum bill rule, Order No.

32. *Id.* at 42,417.

33. *Gas Producers, Market Imperiled as Pipelines Snub FERC Rule*, 83 OIL & GAS J. No. 46, p. 55 (Nov. 18, 1985).

34. The broader issues of deregulation are beyond the scope of this paper. Suffice it to say that views as to the success of deregulation in the banking, telephone and airline industries are by no means unanimous.

35. Take-or-Pay Policy Statement, 47 Fed. Reg. 57,268 (1982).

36. A take-or-pay clause in a producer-pipeline contract requires that a buyer pay a minimum amount whether or not he actually uses that amount. In an earlier rulemaking, the FPC had attempted to soften the impact of take-or-pay clauses by requiring that pipelines be allowed up to five years to use gas paid for under take-or-pay obligations and not actually taken. Order No. 334, 37 F.P.C. 110 (1967).

37. Regulatory Treatment of Payments Made In Lieu of Take-or-Pay Obligations, 50 Fed. Reg. 16,076 (1985).

38. *Id.*

380.³⁹ The rule precludes the collection of any variable costs, including take-or-pay costs, through a minimum bill provision. Pipelines may continue to recover through minimum bills fixed costs actually incurred (*i.e.*, investment in plant necessary to acquire and transport gas), but no purchased gas costs or other variable costs may be recovered under a minimum bill provision.⁴⁰

Prior to the issuance of Order No. 380, the Commission had been directed by two court of appeals decisions to ensure that minimum bills not be allowed to produce discriminatory effects on ratepayers. In *Lynchburg Gas Co. v. FPC*,⁴¹ the Commission had upheld a minimum commodity bill to protect full requirements customers from cost increases caused by swings off the system of partial requirements customers. Recognizing the anti-competitive effect of minimum bills, the *Lynchburg* court held that they could not be authorized absent specific factual findings that customers left on the system would suffer in their absence.⁴²

*Atlantic Seaboard Corp. v. FPC*⁴³ approved Commission standards for allowing minimum bills. One of three goals had to be met. The minimum bill must be designed: (1) to recover that portion of fixed costs allocated to the commodity component of the rate; (2) to protect customers with no alternate source of supply from bearing costs of facilities built to serve those which obtain an alternative source; or (3) to recover take-or-pay costs owed to the pipeline's suppliers. In upholding the Commission, the D.C. Circuit recognized that competition enhanced by the lack of a minimum bill may hurt those left on the system. The court held that the Commission must balance the goal of enhancing competition with protection of system customers who had no alternative sources of supply.⁴⁴

In Order No. 380, the Commission blamed minimum commodity bills as a primary culprit for the failure of price signals to transfer from the burner-tip to the wellhead.⁴⁵ Relying on its authority under Sections 4 and 5 of the Natural Gas Act, the Commission reasoned that rates must reflect costs and that, if rates collect costs that are not incurred, then the rates are unjust and unreasonable.⁴⁶ The Commission also observed that removal of minimum bills should improve pipelines' bargaining power with producers over take-or-pay clause,

39. Order No. 380, 49 Fed. Reg. 22,778 (June 1, 1984) (codified at 18 C.F.R. § 154.111 (1985)), *aff'd*, Order No. 380-A, 49 Fed. Reg. 31,259 (Aug. 6, 1984), *aff'd*, Order No. 380-C, 49 Fed. Reg. 43,625 (Oct. 31, 1984), *aff'd*, *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144 (D.C. Cir. 1985). Minimum bills, found in pipeline-distribution company contracts or retail contracts, are functionally the same as take-or-pay clauses.

40. In a decision issued on the same day as Order 380, the Commission rejected a minimum bill that recovered variable costs and ruled that it should be replaced by a minimum bill limited to recovery of fixed costs. *Colorado Interstate Gas Co.*, 27 F.E.R.C. ¶ 61,315 at 61,582 (1984).

41. 336 F.2d 942 (D.C. Cir. 1964).

42. *Id.* at 947-48.

43. 38 F.P.C. 91, 95 (1964), *aff'd*, 404 F.2d 1268 (D.C. Cir. 1968).

44. 404 F.2d at 1272-74. In a recent decision, the court struck down the Commission's approval of a minimum bill on the grounds that the Commission's decision was not based on specific factual findings to support its conclusion that *Atlantic Seaboard* criteria justified the minimum bill. *Mississippi River Transmission Corp. v. FERC*, 759 F.2d 945 (D.C. Cir. 1985).

45. Order No. 380, *supra* note 39, at 22,781.

46. *Id.* at 22,781-82.

that minimum bill provisions drive industrial customers off of the distribution system and that minimum bills are anti-competitive.⁴⁷ The Commission acknowledged that disallowance of minimum bills would restructure the gas industry and noted that—along with special marketing programs, off-system sales and blanket certificates—the intent of its minimum bill rule was precisely that: to restructure the natural gas industry in order to increase competition.⁴⁸

The Commission has issued three subsequent orders on its minimum bill rule. Order No. 380-A affirmed that the rule extended to minimum take requirements, but postponed its effectiveness with respect to minimum take requirements to November 1, 1984.⁴⁹ Order No. 380-B denied certain requests for specific exemptions from the rule.⁵⁰ Order No. 380-C denied requests for rehearing and created an exception for minimum bills used in connection with transportation rates.⁵¹

Order No. 380-A clarifies that the new minimum bill rule applies to minimum take requirements as well as minimum bills. That is, if physical taking of the gas is required at stated volumes and the customer refuses to take the gas, under 18 C.F.R. § 154.111 the customer cannot be charged for the gas not actually taken. This type of contract clause differs from a provision which states that a customer will pay a specified minimum amount, regardless of the actual gas usage, but the Commission reasoned that it did not intend “to permit pipelines to evade the thrust of this rule” merely by changing the label from minimum bill to minimum take.⁵² However, the Commission agreed to postpone the effectiveness of this aspect of its rule to November 1, 1984 and to reconsider its interpretation in light of further comments. Order No. 380-C, issued after the review of additional comments, affirmed this interpretation, including the effective date of November 1, 1984.

Regarding recovery of take-or-pay costs, Order No. 380-A notes that prudently incurred take-or-pay costs can be recovered by pipelines through some mechanism other than a minimum bill. The precise mechanism for recovery of such costs is left for resolution on a case-by-case basis.⁵³ Noting that it lacks jurisdiction over producer-pipeline take-or-pay clauses respecting decontrolled gas, the Commission stated: “The purpose of the Rule is not to reduce or eliminate take-or-pay obligations. . . ; it is to encourage pipelines (and, inevitably, their producer-suppliers) to institute market responsive *pricing* of natural gas.”⁵⁴

The Commission stated its belief that take-or-pay problems will alleviate as prices drop. Observing that the Commission does not “necessarily support

47. *Id.* at 22,783-84.

48. *Id.* at 22,784.

49. 49 Fed. Reg. 31,259 (1984). Order No. 380-A also granted waivers of the rule for pre-built portions of the Alaska Natural Gas Transportation System and Trunkline LNG Company's tariff respecting importation of liquified natural gas on the grounds that investors were assured of the continuance of the revenue stream provided by these specific minimum bills.

50. *See* 29 F.E.R.C. ¶ 61,076 (1984).

51. 49 Fed. Reg. 43,625 (1984).

52. Order No. 380-A, 49 Fed. Reg. at 31,260.

53. *Id.* at 31,263.

54. *Id.* at 31,265 (emphasis in original).

high take-or-pay levels in producer-pipeline contracts," the Commission noted that resolution of take-or-pay issues could not be accomplished in its minimum bill rulemaking without unduly delaying the effectiveness of the minimum bill rule.⁵⁵

In reaffirming its minimum take ruling, the Commission in Order No. 380-C ruled "minimum take provisions, like minimum commodity bills, act as a restraint on competition because the pipelines and the producers remain artificially insulated from market risk."⁵⁶ In addressing concerns tying minimum take provisions to take-or-pay clauses, the Commission noted that production constraints requiring minimum levels of gas purchases should be reflected in the price of gas, rather than in rigid contract requirements: "The producers are not likely to maintain high prices at the cost of losing valuable reserves. If a specific amount of gas must be sold to maintain a well, the gas will, no doubt, be priced accordingly to accomplish that objective."⁵⁷

Respecting the claim that minimum take provisions are necessary to deter wide pipeline demand swings, the Commission observed that the costs of standing by to serve customers are fixed costs that are not barred by the rule and that such costs can be recovered through appropriate rate design.⁵⁸ The Commission observed:

As the Commission stated in *City of Florence, Alabama v. Tennessee Gas Pipeline Co.*, 24 FERC § 61,395, at 61,839 (1983), competition can and should [sic] play an important role even in a regulated industry such as the natural gas industry. "If competition exists, incentives are created for innovation by the regulated companies. This, in turn, encourages lower prices and better service."

This is precisely what the Commission is attempting to do by adapting our regulations to respond to evolving competitive forces.⁵⁹

The Commission found that a customer faced with "a requirement to take a specific quantity of gas regardless of price or breach of contract became essentially indifferent to price," with the result that "producers become artificially insulated from true market conditions."⁶⁰

FERC's rulings in adjudicatory cases have also attacked take-or-pay clauses. For example, in *Columbia Gas Transmission Corp.*, Opinion No. 204,⁶¹ the Commission considered rates charged by a pipeline through its purchased gas adjustment clauses (PGA), a mechanism which directly passes through actual fuel costs to consumers. Under Section 601 of the NGPA,⁶² such passthroughs are permissible if they do not constitute fraud or abuse. The Commission observed that prices charged under PGA clauses would not be reviewed under the more lenient prudence standard. The Commissioners found that Columbia had been imprudent in purchasing gas at above market prices

55. *Id.*

56. Order No. 380-C, 49 Fed. Reg. at 43,626.

57. *Id.* at 43,628 (footnote omitted).

58. *Id.*

59. *Id.* at 43,629.

60. *Id.* at 43,630.

61. 26 F.E.R.C. ¶ 61,034, *aff'd in relevant part*, Op. No. 204-A, 26 F.E.R.C. ¶ 61,334 (1984), *rev'd and remanded sub nom.* Office of Consumer's Counsel v. F.E.R.C., No. 84-1099 (D.C. Cir. Feb. 4, 1986).

62. 15 U.S.C. ¶ 3431 (1982).

and ignoring the competition offered by No. 6 fuel oil, but that abuse under section 601 had not been demonstrated. The Commission's ruling on this issue was reversed and remanded by the D.C. Circuit in February of 1986.

The Commission also reviewed Columbia's take-or-pay clauses, which were at eighty-five to ninety percent, indefinite price escalators tied to No. 2 fuel oil and most-favored nation clauses. It found that "Columbia's current difficulties are being caused not so much by the amount of gas it bought or the prices it paid, but rather by the operation of the take-or-pay provisions."⁶³ The Commission found that the effect of the take-or-pay provision was unjust, unreasonable and unduly discriminatory and ordered Columbia to renegotiate its contracts or to invoke *force majeure* to avoid the take-or-pay obligation.

In a recent application of its Order No. 380 policy in *Transwestern Pipeline Co* (Opinion No. 238) the Commission struck down a ninety one percent minimum bill in its entirety.⁶⁴ The Commission ruled that a portion of Transwestern's minimum bill was designed to collect the costs of gas not actually taken and therefore was barred by Order No. 380. Regarding the portion designed to recover fixed costs, the Commission ruled that the minimum bill was unduly discriminatory in its effect on two different customers of Transwestern and was therefore unlawful. The Commission, however, overturned the A.L.J. on the appropriate remedy. The A.L.J. had opted for a sixty percent minimum bill, but the Commission held that no minimum bill had been justified. Applying the criteria of Order No. 380, which allowed the use of a minimum bill to recover fixed costs, the Commission held that only fixed costs relative to depreciation and debt service could be recovered through a minimum bill.⁶⁵ In Transwestern's case, the minimum bill was not limited to these elements. Regarding the appropriateness of recovering take-or-pay, the Commission explained that a minimum bill could be used to assess take-or-pay costs on those customers who caused the pipeline to incur take-or-pay liability.⁶⁶ In Transwestern's case, however, there was no link between the minimum bill and Transwestern's take-or-pay liability.⁶⁷

In Order No. 436, the Commission revisited the issue of take-or-pay clauses and minimum bills. Regarding minimum bills, the Commission reaffirmed its Order No. 380 policy. Regarding take-or-pay, the Commission declined the invitation of some to prevent pipelines from recovering take-or-pay payments altogether.⁶⁸ The Commission pointed out that there were take-or-pay claims against pipelines in excess of seven billion dollars, and that these contract rights had been freely negotiated by pipelines and producers. The Commission pointed out that it lacked jurisdiction over producer-pipeline

63. F.E.R.C. at 61,119.

64. 32 F.E.R.C. ¶ 61,009 (1985).

65. *Id.* at 61,031.

66. *Id.* at 61,032.

67. The Commission also rejected the argument that Transwestern should be allowed a 60% minimum bill because its competitor had a 60% minimum bill. *Id.* at 61,032-33.

68. In addition to comments received in Docket No. RM 85-1, the Commission had been requested in proposals filed in four other dockets dating back to 1983 to void or abrogate take-or-pay clauses. Order No. 436, *supra* note 1, at 42,465, n.23.

sales⁶⁹ and that no sound policy reasons for voiding contract rights had been brought to its attention in the comments.

Take-or-pay claims against pipelines have been subject to litigation and intense negotiation over the past few years, leading to settlement agreements and buy-outs at far less than the contract level of the claims. Negotiation and settlement have been triggered due to the invocation of *force majeure* or market-out clauses by major pipelines to avoid take-or-pay liability.⁷⁰ Court decisions support both the right of producers to enforce take-or-pay contract provisions⁷¹ and the right of pipelines to invoke market-out provisions to avoid take-or-pay.⁷² Such disputes are resolved under generally applicable principles of contract interpretation.

The Commission's objective in the NOPR was to encourage negotiated settlement of take-or-pay liability by creating a "safe harbor" presumption of reasonableness for one-time payments made to extinguish take-or-pay liability. In the end, however, the Commission abandoned this approach and decided to retain the policy adopted on April 10, 1985, as set forth in 18 C.F.R. § 2.76.⁷³ The April 10, 1985 policy allows the Commission to review the propriety of take-or-pay liability on a case-by-case basis. The Commission was persuaded that the safe harbor proposal would interfere with private efforts to resolve take-or-pay liability through negotiations or lawsuits, noting that over \$470 million in take-or-pay liability had been settled for approximately \$80 million in seven cases pending before the Commission.⁷⁴

The Commission did, however, adopt a new procedural rule to implement the policy of section 2.76. Under new 18 C.F.R. § 2.77, a pipeline can expedite any abandonment authority needed in connection with a take-or-pay buy-out.⁷⁵ The rule permits a pipeline expeditiously to reduce its obligation to provide gas committed to interstate commerce under a contract subject to take-or-pay. If a buy-out can be negotiated, abandonment and new certificate authority under Section 7 of the Natural Gas Act will be granted as a matter of course. Broader take-or-pay issues, such as the prudence of take-or-pay obligations, will remain subject to review on a case-by-case basis.

In Order No. 436-A, the Commission rejected numerous challenges to the

69. See NGPA § 601(a), 15 U.S.C. § 3431(a) (1982). See also *Pennzoil Co. v. FERC*, 645 F.2d 360, 380-82 (5th Cir. 1981), *cert. denied*, 454 U.S. 1142 (1982).

70. The Commission lists approximately 20 *force majeure* actions by major pipelines since 1982. Order No. 436, *supra* note 1, at 42,418, and Ex. Q. A study by the American Gas Association indicates that nearly 17% of major interstate pipeline gas supplies is subject to take-or-pay clauses. Order No. 436-A, *supra* note 1, at 52,235.

71. See, e.g., *Paragon Resources v. National Fuel Gas Distrib. Corp.*, 723 F.2d 419 (5th Cir. 1984); *Ashland Oil & Refining Co. v. Cities Service Gas Co.*, 462 F.2d 204 (10th Cir. 1972); *Sid Richardson Carbon & Gasoline Co. v. Internorth Inc.*, 595 F. Supp. 497 (N.D. Tex. 1984); *Northwest Central Pipeline Corp. v. Mesa Petroleum Co.*, 576 F.Supp. 1495 (D. Del. 1983); *Lone Star Gas Co. v. McCarthy*, 605 S.W. 653 (Tex. App. 1984); *Northern Natural Gas Co. v. Republic Gas Co.*, 241 P.2d 708 (Kan. 1952).

72. E.g., *American Exploration Co. v. Columbia Gas Transmission Corp.*, ___ F.2d ___, No. 85-3227 (6th Cir. July 30, 1985); *International Minerals & Chemical Corp. v. Llano, Inc.*, 770 F.2d 879 (10th Cir. 1985) (performance excused for commercial impracticability).

73. Order No. 436, *supra* note 1, at 42,462, 42,464.

74. *Id.* at 42,434, 42,464.

75. *Id.* at 42,465; § 2.77, 50 Fed. Reg. 42,487 (1985) (to be codified at 18 C.F.R. § 2.77).

substance of Order No. 436 including the argument that transportation should be made available only to producers who agree to reduce their take-or-pay claims.⁷⁶ The Commission stressed that Order No. 436 does not abrogate contract rights or preclude renegotiation of contracts.⁷⁷ Responding to pipelines' arguments that Order No. 436 reduces pipelines' bargaining power in take-or-pay negotiations, the Commission observed that expedited approval of abandonment would not provide any independent transportation authority, and that producers' needs for transportation would preserve pipelines' bargaining power.⁷⁸ In overruling objections to the expedited abandonment procedures of new section 2.77, the Commission explained that its objective in adopting the rule was to free-up low cost gas shut-in by pipelines in favor of higher cost supplies.⁷⁹ The Commission hoped thereby to alleviate market disorders caused by the shutting-in of low cost gas in order to increase takes of higher-priced, take-or-pay supplies.⁸⁰

The Commission's actions on contract provisions are part of its deregulation policy. Total lack of regulation would allow companies the freedom to negotiate contract provisions, such as take-or-pay and minimum bills, according to economic needs and relative bargaining power. The Commission's reliance on the market to allocate resources requires a market that is truly free, which in turn requires regulation to prevent monopolistic tendencies and to foster competition. The Commission's rulings in this area must be viewed as pro-competitive, designed to discourage monopolistic practices that would otherwise distort free market forces.

III. SPOT MARKET FOR NATURAL GAS

In Order No. 436, the Commission declared that it would unbundle gas commodity costs and transportation services from other cost elements in gas sales.⁸¹ In support of this approach, the Commission pointed to an interstate spot market for gas that had recently developed and is now flourishing.⁸² Spot market transactions now total between 2 to 2.5 trillion cubic feet per year compared to total gas consumption of about 17 to 18 trillion cubic feet.⁸³ The primary purpose of Order No. 436 is to encourage the growth of a commodity market for gas, primarily by encouraging transportation as a separate service.

The interstate gas commodity market, a relatively recent phenomenon, owes its existence to special marketing and off system sales programs approved by FERC.

76. Order No. 436-A, *supra* note 1, 50 Fed. Reg. at 52,226.

77. *Id.* at 52,258.

78. *Id.* at 52,226.

79. *Id.* The Commission slightly modified the procedures of section 2.77 regarding the period of time allowed to respond to applications under the rule. *Id.* at 52,260.

80. See Op. No. 245, *infra*, for a further refinement of Commission policy on this issue.

81. Order No. 436, *supra*, note 1, at 42,413, 42,422-23.

82. *Id.* at 42,419-20.

83. Order No. 436-A, *supra* note 1, at 52,233.

A. SMPs and LTAs

In 1983 and 1984, the FERC approved special marketing programs (SMPs) that were established by many pipelines in an effort to encourage the sale of excess gas resulting from the prevailing oversupply and to reduce take-or-pay liability.⁸⁴ As described by the Commission:

The SMPs were also designed to make possible the recapture of lost markets, the retention of existing markets, and the acquisition of new markets. These objectives would be achieved by the release of contracted supplies and the sale of these supplies at prices more nearly approximating their commodity value.⁸⁵

Approval of the SMPs was on an experimental basis, and each was to expire on October 31, 1984.⁸⁶ The Commission required each pipeline to file reports during the experimental period,⁸⁷ and the Commission solicited public comments concerning SMPs in a notice of inquiry issued on January 26, 1984.⁸⁸ On September 26, 1984, the Commission extended the SMPs for an additional year to October 31, 1985, and established uniform terms and conditions for each SMP.⁸⁹

SMPs involved direct producer sales of gas previously committed by contract to a pipeline or distributor. Under an SMP, the gas is released from the contract and sold directly by the producer to the distributor or end-user at a lower price, with transportation of the released gas provided by the pipeline. The advantage of the program lies in the producer concession.⁹⁰ In an SMP, a pipeline burdened with take-or-pay liability and the producer facing lot sales agree to release a specified amount of gas from their contract and to sell that gas at a market responsive price.⁹¹ As the Commission explained in its order on rehearing, "[t]he SMPs were designed to balance supply and demand and to provide a net benefit to a pipeline's system by allowing the pipeline to reduce both its cost of gas and its take-or-pay exposure."⁹²

Initially, SMP gas could only be sold to new loads or loads that would

84. SMPs were first authorized in a series of letter orders for Transcontinental Gas Pipe Line Corp., 23 F.E.R.C. ¶ 61,199, 23 F.E.R.C. ¶ 61,221, 23 F.E.R.C. ¶ 61,400 (1983), which were then amended by the Commission, 25 F.E.R.C. ¶ 61,219 (1983), *modified*, 26 F.E.R.C. ¶ 61,029 (1984).

85. *Tenneco Oil Co. et. al.*, 28 F.E.R.C. ¶ 61,383 (1984).

modifying 25 F.E.R.C. ¶ 61,234 (1983); Transcontinental Gas Pipe Line Corp. 26 F.E.R.C. ¶ 61,029 (1984), *modifying* 25 F.E.R.C. ¶ 61,129 (1983); Columbia Gas Transmission Corp. 26 F.E.R.C. ¶ 61,031 (1984); *modifying* 25 F.E.R.C. ¶ 61,220 (1983); Tennessee Gas Pipeline Co., 25 F.E.R.C. ¶ 61,398 (1983), *modified on reh'g*, 26 F.E.R.C. ¶ 61,381 (1984), *clarified*, 26 F.E.R.C. ¶ 61,398 (1984); *modified on rehearing*, 26 F.E.R.C. ¶ 63,054 (1984); Texas Eastern Transmission Corp., 27 F.E.R.C. ¶ 61,493 (1984); TXP Operating Co., 28 F.E.R.C. ¶ 61,189 (1984); Amoco Prod. Co., 28 F.E.R.C. ¶ 61,224 (1984); and El Paso Natural Gas Co., 28 F.E.R.C. ¶ 61,284 (1984).

87. Reporting requirements are continued for the extension period, but the requirements have been eased. *Tenneco Oil Co.*, 28 F.E.R.C. at 61,688 (1984).

88. *Impact of Special Marketing Programs on Natural Gas Companies and Consumers* (SMP NOI), 49 Fed. Reg. 3193 (1984).

89. *Tenneco Oil Co. et. al.*, 28 F.E.R.C. ¶ 61,383, *modified*, 29 F.E.R.C. ¶ 61,334 (1984).

90. See Tiano and Brownfield *The Impact on Gas Distribution Companies of Federally Approved Special Marketing Programs*, 5 ENERGY L.J. 287, 299-301 (1984).

91. The releasing pipeline *must* be absolved of take-or-pay liability for released SMP gas. 28 F.E.R.C. at 61,688.

92. 28 F.E.R.C. at 61,688.

otherwise be served by alternative fuels, or through producers' direct sales or off-system sales.⁹³ In its September 26, 1984, order, eligibility was enlarged to allow anyone with a firm contractual entitlement to gas from a releasing pipeline to purchase up to ten percent of its entitlement under an SMP. This change responded to charges of discrimination from on-system customers regarding off-system sales and lower prices allowed by the earlier SMPs.⁹⁴

Initially, SMPs could only utilize gas the average cost of which was equal to or greater than the releasing pipeline's weighted average cost of gas for its entire system supply (WACOG).⁹⁵ Expanding eligibility to include on-system customers led the Commission to drop the WACOG requirement. Because the WACOG requirement was meant to protect on-system customers from loss of low cost gas, the Commission reasoned that the expanded eligibility would obviate this requirement. The Commission substituted a requirement that precludes the release or sale under an SMP of gas with a maximum lawful price in excess of the section 109 price.⁹⁶

Under an SMP, a releasing pipeline must transport released gas to the new purchaser of that gas.⁹⁷ Transportation must be provided for SMP gas nominated by a firm customer under the ten percent of firm requirements condition.⁹⁸ The Commission requires that the rate for transportation be on a fully allocated cost-of-service basis, but allows less than a fully allocated rate if the pipeline agrees not to collect the unrecovered cost from its other customers. Thus, participation in SMPs carried with it an obligation on the part of pipelines to provide transportation.

On May 10, 1984, the United States Court of Appeals for the D.C. Circuit overturned the SMP approved for Columbia Gas Transmission Corporation in *Maryland Peoples Counsel v. FERC (MPC I)*, calling into question the entire SMP program. The court stated that it was reviewing only the Commission's power to exclude, from the category of authorized purchasers of released gas, the pipeline's "captive customers or (as the Commission calls them) 'core market'—i.e., those customers who have no readily available alternative source of fuel."⁹⁹ The court ruled that the restriction was impermissible because it unjustly discriminated against core market customers of Columbia. The court's reasoning was based on the conclusion that all of the Commission's reasons for allowing the restriction concerning core market customers were reasons for upholding SMPs in general, not for limiting their benefits by excluding core customers. The Commission had argued that fixed costs would be re-

93. 49 Fed. Reg. at 3194 (1984).

94. 28 F.E.R.C. at 61,686. Eligibility was also enlarged to include loads capable of being served by alternative fuels even where the capability to burn an alternative fuel is not presently installed. The purpose of this change was to discourage uneconomic investment in alternative fuel capabilities from being undertaken solely to qualify for an SMP. 28 F.E.R.C. at 61,687.

95. 49 Fed. Reg. at 3197 (1984).

96. 28 F.E.R.C. at 61,687.

97. The Commission, in its order on rehearing, noted that to add an equal access stipulation for transportation would be "problematic" because pipelines are not common carriers. 29 F.E.R.C. at 61,700 (1984).

98. *Id.*

98.1 28 F.E.R.C. at 61,687.

99. *Maryland Peoples Counsel v. FERC*, 761 F.2d 768, 774 (D.C. Cir. 1984) [hereinafter cited as *MPC I*].

duced for the core market because the SMP would allow retention of industrial customers who would otherwise switch to alternate fuels and that the SMP would reduce take-or-pay exposure. The court observed that both benefits would be available if core market purchasers were eligible to participate in the SMP.¹⁰⁰ The court also noted that exclusion of the core market would foster monopoly pricing because pipelines are "backward vertically integrated" with production subsidiaries. "This backward integration provides significant incentives for pipelines to pay above-market prices for the gas they purchase, producing increased profits to their production affiliates."¹⁰¹ Because fixed costs account for only fifteen percent of wholesale gas rates, the potential to increase profits through raising the variable cost component of wholesale rates—the purchase price of gas—was not offset by the fixed cost spreading effect of the SMP.¹⁰² The Commission's fatal error, ruled the court, was its failure to hold hearings or otherwise inquire into this aspect of the SMP.

MPC I did not directly overturn the reauthorization of SMPs effected by the Commission's September 26, 1984 order. *MPC I* reviewed only the earlier orders applicable to the Columbia system alone, which authorized the Columbia SMP until October 31, 1984.¹⁰³ As noted above, the September 26, 1984 order was issued on the basis of comments received in response to a notice of inquiry, and the blanket core market limitation was altered to allow purchases of up to ten percent of firm loads from the SMPs. In a subsequent opinion, *MPC III*, addressing the extension of the SMPs to October 31, 1985, the court was unimpressed with the ten percent modification for core customers: "[W]e are persuaded that the new SMP orders are of a piece with the old. They proceed on the same premises and aim to solve the same problems. They may be marginally less discriminatory than their predecessors, but they continue to entail identical lapses of logic and evidence."¹⁰⁴

However, since the SMPs would expire a mere three months after the date of the decision (August 6, 1985), the court decided to allow them "a natural death."

As a result of *MPC I* and *MPC III*, SMPs have now died a natural death. FERC has so held, and has replaced them with limited term abandonments (LTAs).¹⁰⁵ Under an LTA, gas previously committed to interstate commerce may be sold in the spot market and transported by any means allowed under Order No. 436. Abandonment authority is granted: (1) for a limited term (i.e., until March 31, 1986), after which the gas supply is recommitted to interstate commerce; and (2) provided that the price of the gas exceeds the section 109 price. For LTAs, the Commission relies on its new expedited procedures established by Order No. 436¹⁰⁶ to allow abandonment of gas previously committed

100. *Id.* at 775.

101. *Id.* at 776.

102. *Id.* at 776-67.

103. Columbia Gas Transmission Corp., 25 F.E.R.C. ¶ 61,220 (1983), *aff'd*, 26 F.E.R.C. ¶ 61,031 (1984).

104. Maryland People's Counsel v. F.E.R.C., 768 F.2d 450, 455 (D.C. Cir. 1985).

105. Columbia Gas Transmission Corp., 33 F.E.R.C. ¶ 61,233 (1985); Amoco Production Co., 33 F.E.R.C. ¶ 61,173 (1985); Tenneco Oil Co., 33 F.E.R.C. ¶ 61,134 (1985).

106. § 2.77 *supra*, 50 Fed. Reg. at 42,487.

to interstate commerce.¹⁰⁷

The Commission has described LTAs as a temporary arrangement to "bridge" between the prior spot market programs and expedited abandonment authorized by Order No. 436:

Today's order is necessary because there has been a certain amount of reliance developed around established spot market arrangements; and an expectation that they would continue in some form. As we begin to implement the blueprint of RM85-1-000, the LTAs serve as a necessary bridge between existing spot market arrangements and abandonments as provided for in Order No. 436.¹⁰⁸

Responding to claims that LTAs may be discriminatory, the Commission noted that, because the abandoned gas could be sold without restriction, there were no discriminatory features.¹⁰⁹

In *Felmont Oil Corp. and Essex Offshore, Inc.*, Opinion No. 245, the Commission, in a section 7(b) proceeding, approved an LTA involving Section 104 and Section 106(a) gas and lasting for thirty-six months.¹¹⁰ Relying on Commission and judicial precedent, the A.L.J. had rejected the request for abandonment of old gas supplies committed to interstate commerce. The Commission reversed the A.L.J., citing its Order Nos. 436 and 380 as the justification for establishing new abandonment criteria:

In Order Nos. 436, 380 and others, we have greatly facilitated the ability of gas purchasers to acquire supplies from alternate suppliers, thereby fostering the development of a national market. We also find that gas now competes much more actively with other fuels. Gas users with the ability to switch fuels have been very sensitive to swings in natural gas prices and quickly respond to price increases by switching to available cheaper fuel sources.

Since the NGPA created in essence a more unified national gas market, with prices and allocation of supplies determined to a greater extent by market forces, the rationale for the prior abandonment policy is far less compelling. The fundamental changes evolving in the gas industry under the NGPA support the Commission's decision to take a broader approach to abandonment issues such as those here involved. In order to make a finding as to the public convenience or necessity, the Commission must look at a wider range of factors than it has previously considered.¹¹¹

Finding that "lower cost supplies of gas are being shut-in in favor of higher takes of more expensive supplies," the Commission determined to approve abandonment of shut-in gas so that it can lower the overall cost of gas.¹¹² The Commission was quick to point out that it was not rejecting the previous public interest criteria for abandonment *in toto*, but rather was modifying the criteria to increase competition in the gas market:

Thus, where a party can demonstrate that abandonment in a particular instance would have beneficial effects on the market overall, such as increasing competition and causing gas prices to respond to that competition, and the benefits of the abandonment outweigh any adverse effect to the purchaser to whom the gas is presently dedicated, or that purchasers' customers, . . . such abandonment may be conditioned in order to mitigate

107. *Vesta Energy Co.*, 33 F.E.R.C. ¶ 61,326 at 61,636 (1985).

108. *Tenneco Oil Co.*, 33 F.E.R.C. at 61,298.

109. *Id.* at n.5.

110. 33 F.E.R.C. ¶ 61,333 (1985).

111. *Id.* at 61,656.

112. *Id.*

the loss to the dedicated purchasers.¹¹³

Several features of the Opinion No. 245 LTA are noteworthy. First, the abandoned gas is old interstate gas, not priced above the section 109 ceiling price. Second, the program is authorized for thirty-six months rather than three months. Third, the pipeline that had shut-in the gas remains eligible to buy some or all of the abandoned gas according to its needs. This latter feature is implemented by the pipeline's ability to nominate the amount of gas it will buy for a six-month period.¹¹⁴ The amount not nominated and purchased may be sold by the producer on the spot market through the end of that period. The procedure is repeated for each succeeding six-month period.

The Commission did not address MPC issues in Opinion No. 245. FERC relied on the fact that the abandonment is for producer gas and that the pipeline remains eligible to purchase all of its previous entitlement. Whether the pipeline's customers can independently purchase the abandoned gas was not addressed.

B. Off-System Sales and Discounted Sales

In addition to SMPs, FERC has approved off-system sales, which the Commission defines as a sale of natural gas "that is excess to the pipeline's current demand, that is of a short-term, interruptible nature, and that is made to a customer outside or away from the pipeline's traditional or historic market area."¹¹⁵ Initially, off-system sales, approved on a case-by-case basis in late 1980, were made to allow pipelines short of gas supplies to purchase gas from pipelines with a surplus.¹¹⁶ As the gas surplus became more widespread, off-system sales were viewed as a means of dealing with what was viewed as a short-term deliverability surplus without impairing long-term supplies.¹¹⁷ The rationale was that pipelines would be allowed to make off-system sales to reduce take-or-pay exposure arising from the short-term surplus while continuing to contract for long-term gas supplies.

On April 25, 1983, the Commission issued its Off-System Sales Statement of Policy.¹¹⁸ Addressing comments received at a November 1982 conference, the Commission announced the policy that it would apply in future off-system sales applications. Four objectives for off-system sales were defined:

- (1) Permit pipelines with excess gas supplies to sell to pipelines (interstate, Hinshaw, or intrastate) and local distribution companies experiencing a physical gas shortage.
- (2) Permit pipelines with excess gas to sell to pipelines, local distribution companies, and end-users who would otherwise purchase more expensive gas.
- (3) Ameliorate take-or-pay problems.
- (4) Accomplish the first three objectives without unduly burdening the selling

113. *Id.* at 61,657.

114. *Id.* at 61,658.

115. Off-System Sales, Statement of Policy, 23 F.E.R.C. ¶ 61,140 at 61,305 (1983).

116. *Id.* An SMP may include off-system sales, but SMPs can be established by producers, LDCs and brokers, as well as pipelines. Off-system sales are always by pipelines and usually are to other pipelines or LDCs.

117. 23 F.E.R.C. ¶ 61,140 at 61,305 (1983).

118. *Id.*

pipeline's traditional customers and without simply transferring problems of the interstate pipelines to the intrastate market.¹¹⁹

To meet the objections of pipeline system customers, FERC established criteria to prevent off-system sales from diluting the cushion of low cost gas in a pipeline's systemwide gas mix. FERC criteria also addressed the concern of system customers that off-system sales deplete reserves that properly belong to the pipeline's system customers and should be saved for their future use. The Commission required that off-system sales only be made when a pipeline has reserves that are surplus to its long-term needs and only when needed to avoid take-or-pay liability. The three criteria, as framed by the Commission, are:

- (1) Where the proposed sale is between two interstate pipelines, the transaction should be priced at the higher of the selling pipeline's system average load factor rate (based upon the rates in effect at the time the transaction is proposed) or its average section 102 gas acquisition cost (based upon its most recent purchased gas adjustment filing). Where the purchaser is not another interstate pipeline, the selling pipeline would be free to negotiate a higher rate.
- (2) To be eligible for off-system sales, the selling pipeline must demonstrate a surplus sufficient to demonstrate that existing customers will not be impaired and must also demonstrate at least potential take-or-pay liability.
- (3) The off-system sales cannot be firm, but must be temporary (limited to one year in duration) and must be made on a "best efforts" or interruptible basis.¹²⁰

As part of its Order No. 319 transportation program,¹²¹ FERC authorized off-system sales by interstate pipelines to other interstate pipelines. To qualify, a selling pipeline must have surplus gas and potential take-or-pay liability, the sales price must be at the higher of its system average load factor rate or the average section 102 gas acquisition cost and the transaction must be limited to one year.¹²² The Commission asserted that the program was consistent with its statement of policy on off-system sales.¹²³

Because of the pipelines' asserted inability to sell gas under the price criterion included in the Statement of Policy, the FERC modified the policy. A presiding administrative law judge, in a decision affirmed by the Commission, allowed the Natural Gas Pipeline Company of America to make off-system sales at its commodity price, which was substantially below the price determined according to the Statement of Policy.¹²⁴ In *Consolidated Gas Supply Company*, FERC released the one-year requirement and allowed off-system sales for a three-year period.¹²⁵

In affirming the A.L.J. in the *Natural Gas Pipeline* case, the Commission observed that it was not rescinding its Policy Statement. Rather, the Commission noted that the Policy Statement "was not intended to be a hidebound, cast-

119. *Id.* at 61,306.

120. *Id.* at 61,307-08.

121. 48 Fed. Reg. 34,875, 34,882 (1983).

122. 18 C.F.R. § 157.210 (1984).

123. 48 Fed. Reg. at 34,883.

124. Natural Gas Pipeline Co. of Am., 26 F.E.R.C. ¶ 63,042 at 63,073 (initial decision), *aff'd*, 27 F.E.R.C. ¶ 61,235 at 61,452 (1984).

125. 25 F.E.R.C. ¶ 61,355 (1983).

in-stone rule."¹²⁶ Here, the Commission reasoned, the lower rate proposed was found on the record to be compensatory and non-discriminatory. The Commission noted that on-system customers would benefit from the off-system sale by the decrease in fixed costs, including the mitigation of take-or-pay liability. The Commission ordered that the off-system revenues be credited to Account 191.¹²⁷

The Commission took the opportunity in its order denying rehearing in the *Natural Gas Pipeline* case to further refine its Statement of Policy. The Commission substituted a net economic benefit test for its earlier selling price criterion (higher of off-system average load factor rate or section 102 gas acquisition cost) and reaffirmed the other criteria of the Policy Statement without change:

In the instant order, the Commission recognizes that the objectives outlined in the Statement of Policy no longer represent the only appropriate foci for considering the merits of off-system sales applications. . . . We consider the net economic benefit test applied herein to be the proper standard for considering the impact of off-system sales on on-system customers in today's marketplace. This standard, as should be obvious from the previous discussion, may include considerations of take-or-pay liability and contribution to fixed costs. These, however, are by no means the only relevant factors to be considered and the relevant factors may, in fact, vary in number and weight on a case-by-case basis.¹²⁸

Off-system sales are subject to the same criticisms made in *MPC I* (and reiterated in *MPC II*,¹²⁹ and *MPC III*) concerning SMPs. The "net economic benefit" criterion applied in *Natural Gas Pipeline* is essentially the same justification argued by FERC in *MPC I*. In *MPC I*, the argument that an SMP produces benefits to on-system customers because it lowers fixed costs was rejected because fixed costs would also be lowered if on-system customers were eligible for the SMP's reduced rate. The same could be said of the rationale applied in *Natural Gas Pipeline*: net economic benefits, defined as reduced fixed costs, would also be generated by lowering rates down to the off-system sales level for on-system customers because lower rates should increase on-system sales. If "net economic benefits" cannot justify discriminatory rates in SMPs, then they cannot justify discriminatory rates for off-system sales.¹³⁰

The Commission recently passed up an opportunity to amend the net-economic-benefit test, as expanded by the *Natural Gas Pipeline* case.¹³¹ And, in setting for hearing a request to approve an off-system sales program, the Commission has tied off-system sales to its new Order No. 436 transportation policy. In *ANR Pipeline Co.*, the Commission observed that blanket transportation authority for gas sold under an off-system sales program would have to be

126. 27 F.E.R.C. at 61,452.

127. *Id.* at 61,453.

128. *Natural Gas Pipeline Co. of Am.*, 28 F.E.R.C. ¶ 61,174 at 61,330 (1984). *Accord* Consolidated Gas Transmission Co., 29 F.E.R.C. ¶ 61,022 (1984). In *Consolidated*, the off-system sales rate was found to recover all commodity costs plus part of fixed costs, but it was nevertheless lower than any on-system rate. It was ruled that the off-system service would be lowest in priority.

129. *Maryland People's Counsel v. FERC (MPC II)*, 761 F.2d 780 (D.C. Cir. 1985).

130. Subsequent to *MPC I*, the FERC declined to approve off-system sales for Tenneco in advance of a hearing on the issue of discrimination. No mention of *MPC I* was made in the order. *Tennessee Gas Pipeline Co.*, 32 F.E.R.C. ¶ 61,092 (1985).

131. *Tennessee Gas Pipeline Co.*, Opinion No. 208-B, 33 F.E.R.C. ¶ 61,382 (1985).

obtained under Order No. 436.¹³² Whether the contract demand reduction right under Order No. 436 is sufficient to remedy the shortcomings of the net-economic-benefit justification has not yet been ruled upon by the courts. Absent judicial rulings to the contrary, FERC obviously intends to continue to authorize off-system sales under its modified off-system sales policy.

Discounted sales to on-system industrial customers had been approved by the Commission at rates below those charged to core customers. The Commission ruled that such sales had to be at the company's risk: any shortfall in cost recovery caused by discounted sales could not be shifted to core customers.¹³³ The rationale for allowing the admittedly discriminatory rates was the familiar "net economic benefit" theory: without the discounts, fuel switchable customers would leave the system causing increases in fixed costs for core customers. As noted, the rationale cannot withstand the type of scrutiny applied in *MPC I* and *MPC II*. In a recent case, the Commission disallowed continuation of a discounted sales program due to its discriminatory effect in an opinion acknowledging *MPC I* and *MPC II* and the changes wrought by Order No. 436.¹³⁴ Accordingly, like SMPs, discounted sales are a thing of the past. The Commission's free market policy is obvious in actions taken to promote the development of a spot market for gas. It is in this area that the Commission has collided directly with more traditional public utility policies. The *MPC* decisions have warned the Commission that it must retain regulatory controls in some areas in order to protect captive pipeline customers, people who cannot participate on an equal footing in an unregulated, commodity market. Order No. 436 recognizes these constraints and pledges to retain utility-type regulation of certain areas of the natural gas industry.¹³⁵

IV. TRANSPORTATION

SMPs and off-system sales raise important questions, addressed in *MPC I*, regarding the sharing of fixed costs and access to cheaper sources of supply. To an extent, all system customers benefit when the overall volume of sales rises and, therefore, these programs can produce real "net economic benefits." With lower rates, dual fuel customers can be enticed to remain on-system to share fixed costs with captive or core customers. Take-or-pay liability that otherwise might be born by core customers can be reduced. But the danger is that core customers may not share "net economic benefits" equitably. Pipelines may sell cheap gas to non-core customers but continue to charge high rates to captive customers. In that scenario, a pipeline takes advantage of its monopoly power over its captive customers to enhance its competitive position in the non-monopolized market. The danger is acknowledged in Order No. 436 and discussed at some length.

132. ANR Pipeline Co., 33 F.E.R.C. ¶ 61,201 (1985). As an alternative to blanket transportation authority, the Commission indicated that specific, third-party transportation arrangements could be approved under section 7(c) of the Natural Gas Act.

133. Northern Natural Gas Co., 27 F.E.R.C. ¶ 61,299 (1984), *reh'g denied*, 28 FERC ¶ 61,230 (1984); Panhandle Eastern Pipe Line Co., 29 F.E.R.C. ¶ 61,125 (1984).

134. Northern Natural Gas Co., 33 F.E.R.C. ¶ 61,066 (1985).

135. Order No. 436, *supra* note 1, at 42,413.

Core customers cease to be captive customers if they can choose among suppliers. Making alternative suppliers available breaks the monopoly in a given market. The key to opening the market is access to alternative gas supplies, and access in the gas industry means transportation. FERC has called transportation—referred to in the industry as contract carriage¹³⁶—the cornerstone of its efforts to restructure the natural gas industry.¹³⁷

The Natural Gas Act discourages contract carriage because a certificate issued after hearings is required for each transaction, and prior approval of abandonment must be obtained if the service is stopped. The procedures are so complex that only long-term, fixed arrangements are practical.

Prior to the enactment of Order No. 436, FERC had adopted programs to encourage contract carriage.¹³⁸ Section 7(c) of the Natural Gas Act¹³⁹ allows exceptions from certificate requirements for certain types of temporary or emergency transportation arrangements, and the Commission implemented blanket certificate programs under this authority. Codified in Subpart F of 18 C.F.R. Part 157, the rules adopted by Order Nos. 234-B¹⁴⁰ and 319 permitted an interstate pipeline to obtain, in a single proceeding under Section 7 of the Natural Gas Act, authority to engage in a range of contract carriage transactions.¹⁴¹ Pre-grant of abandonment and approval for construction of necessary facilities was included in the blanket certificate,¹⁴² and for certain types of transactions no prior notice to the Commission was required.¹⁴³ For others, prior notice was required but approval was automatic, unless a timely objection by an intervenor was made.¹⁴⁴ Reporting of all transactions was required.¹⁴⁵

Transportation on behalf of a high priority end-user or gas owned by the end-user or purchased from a producer, intrastate pipeline or local distribution company (LDC) was authorized without prior notice to the Commission for a term of five years (ten years if the end-user owned the production).¹⁴⁶ For a longer term, prior notice was required. Transportation on behalf of an LDC, intrastate pipeline or interstate pipeline was also authorized on prior notice.¹⁴⁷ The notice of the Commission had to describe the parties and the transactions and include a copy of the contract.¹⁴⁸

For a temporary, experimental period extending from August 5, 1983 to

136. See Mogel and Gregg, *Appropriateness of Imposing Common Carrier Status on Interstate Natural Gas Pipelines*, 4 ENERGY L.J. 155 (1983).

137. Order No. 436, *supra* note 1, at 42,424.

138. Order Nos. 234-B and 319 streamlined several separate transportation programs adopted under earlier Commission orders, see Order No. 319, 48 Fed. Reg. 34,875, 34,876-67 (Aug. 1, 1983). For a description of the earlier transportation programs, see Means and Angyal, *The Regulation and Future Role of Direct Producer Sales*, 5 ENERGY L.J. 1, 5-16 (1984).

139. 15 U.S.C. § 717f(c) (1982).

140. Order No. 234, 47 Fed. Reg. 24,254 (1982); Order No. 234-B, 48 Fed. Reg. 34,872 (1983).

141. The proceeding is expedited because a certificate is granted if enumerated criteria are met. A full-dress section 7 inquiry is not required. See *MPC II*, 761 F.2d at 783.

142. 18 C.F.R. §§ 157.208, 157.216 (1985).

143. *Id.* at § 157.203(c).

144. *Id.* at § 157.205.

145. *Id.* at § 157.207.

146. *Id.* at § 157.209(b)(3).

147. *Id.* at § 157.209(b)(3).

148. *Id.* at § 209(c).

June 30, 1985, gas not dedicated to interstate commerce prior to enactment of the NGPA could be transported for any end-user under a blanket certificate.¹⁴⁹ Transportation without notice was authorized for 120 days, and transportation for a longer period was authorized after notice.

Rates for end-user transportation under Part 157 blanket certificates could include an incentive allowance of \$.05 per MMBtu.¹⁵⁰ The pipeline was allowed to retain the incentive allowance plus an additional \$.01 per MMBtu as a return on its service but the remainder of the revenues had to be credited to the cost of service for system customers.¹⁵¹

In addition to blanket certificates under section 7 of the Natural Gas Act, the Commission had adopted a self-implementing transportation program under section 311(a) of the NGPA.¹⁵² Under Subpart B of Part 284, an interstate pipeline or an LDC could transport gas without prior Commission approval for the transporter's system supply.¹⁵³ An intrastate pipeline was also authorized to transport gas on behalf of an interstate pipeline or an LDC for system supply for up to two years.¹⁵⁴ If the intrastate pipeline sought transportation for an end-user, the end-user had to qualify under Subpart F of Part 157.¹⁵⁵ For longer periods or different uses of the transported gas, specific authorization could be sought.¹⁵⁶ An interstate pipeline could use a rate for transportation from a published rate schedule or a rate based on the transportation component identified in its last major rate case.¹⁵⁷ The pipeline as a general rule was allowed to retain \$.01 per MMBtu, and was required to credit all other revenues to the cost of service for its system customers.¹⁵⁸

Blanket certificates after expedited hearings held under Section 7 of the Natural Gas Act were also authorized for interstate pipelines transporting gas for any other interstate pipeline's system supply.¹⁵⁹ Intrastate and Hinshaw pipelines and LDCs could also obtain authority to transport interstate gas without thereby subjecting themselves entirely to FERC jurisdiction.¹⁶⁰

In Order No. 319, the Commission stated that the \$.05 per MMBtu incentive charge allowed for end-user transportation was not appropriate for transportation under Part 284 because pipelines and LDCs were receiving the transportation they needed, while end-users seeking transportation under § 157.209 certificates were not.¹⁶¹ Order No. 319-B held that the additional incentive charge authority of \$.05 per MMBtu authorized in section 157.209 would expire as of January 18, 1985.

149. *Id.* at § 157.209(e). The temporary program was established by Order No. 234-B, *supra* note 140.

150. 18 C.F.R. § 157.209(f) (1985).

151. *Id.* at § 157.206(h).

152. 15 U.S.C. § 3371(a) (1982).

153. 18 C.F.R. § 284.102 (1985).

154. *Id.* at § 284.122.

155. *Id.* at § 284.122(b)(ii).

156. *Id.* at §§ 284.107, 284.127.

157. *Id.* at § 284.103(c).

158. *Id.* at § 284.104(d).

159. *Id.* at § 284.221.

160. *Id.* at § 284.222.

161. Order No. 319, 48 Fed. Reg. 34,875 at 34881 (1983).

The temporary end-user blanket certificate program authorized by Order No. 234-B was challenged in a companion case to *MPC I, Maryland People's Counsel v. FERC (MPC II)*.¹⁶² In *MPC II*, the court ruled that the blanket certificate program for end-users authorized under 18 C.F.R. § 157.209(e) did not provide adequate protection for FERC's "prime constituency—the consumers." The case was remanded to FERC for an inquiry into the anti-competitive effects of the Order No. 234-B program.

The court observed that pipelines possess monopoly power in their system markets and, because they are "backward vertically integrated" (they own production affiliates), they have an incentive to pay high prices for gas purchased from their own affiliates.¹⁶³ The only competitive spur to prevent monopoly pricing, *since alternative gas transportation is unavailable to core customers*, is the fear of losing those customers who are capable of switching to alternative fuels.¹⁶⁴ Summarizing MPC's arguments, the court noted that, normally, prices cannot be lowered to fuel-switchable customers without offering similar price breaks to all, but Order No. 234-B permits lower prices for fuel-switchable customers without affording similar benefits to core customers: "[o]nly by conditioning blanket certificates on the nondiscriminatory provision of service to captive and noncaptive consumers alike, MPC maintains, can FERC permit transportation of direct-sale gas to fuel-switchable end-users without consigning other consumers to exploitation at the hands of interstate pipelines."¹⁶⁵

The court essentially agreed with MPC's contention, ruling that FERC had not addressed the anti-competitive issues raised by MPC and had not justified its discriminatory treatment of core customers. The court specifically rejected FERC's argument that the end-user transportation program, by lowering fixed costs chargeable to core customers, was fair. Just as it did in *MPC I*, the court rejected the rationale underlying FERC's "net economic benefit" criterion.

Order No. 436 was issued not long after *MPC I* and *MPC II* and mentions these cases at several points in the explanation of the rulemaking. The Order builds on two points stressed in *MPC II*: it makes transportation available on a non-discriminatory basis, thereby meeting the MPC's chief objection; and it attempts to entice pipelines into providing non-discriminatory transportation to system and non-system customers on equal terms, which if implemented would vitiate the court's assumption that transportation is unavailable to core customers.¹⁶⁶

The heart of the new rules is the new approach to transportation.¹⁶⁷ As explained by the Commission, the NGPA abolished the jurisdiction of the Commission over wellhead prices (except for old interstate gas) and limited its

162. *MPC II*, 761 F.2d 780 (D.C. Cir. 1985).

163. *Id.* at 784.

164. *Id.*

165. *Id.* at 785.

166. The transportation requirements rest on an explicit finding of unduly discriminatory conduct.

167. Order No. 436 also promulgated rules designed to expedite certificate and abandonment procedures, particularly those required to change facilities or to build new facilities necessary to market gas more competitively. See Subpart E, 50 Fed. Reg. 42,488-90 (1985) (to be codified at 18 C.F.R. Subpart E).

jurisdiction over city-gate gas costs,¹⁶⁸ but left intact its jurisdiction to issue certificates for services and facilities and to establish just and reasonable rates for transportation of natural gas. The purpose of the new rules is to encourage competition in a newly-developed commodity market for natural gas, while retaining regulatory controls to protect consumers in areas where competition does not provide that protection. Specifically, FERC seeks to unbundle gas costs from transportation costs, allowing the market free play for the former while retaining utility regulation of transportation terms and rates.¹⁶⁹

The new rules do five things to facilitate transportation:

- Provide incentives for pipelines to offer non-discriminatory contract carriage, including blanket certificates under Section 7 of the Natural Gas Act, self-implementing transportation under section 311 of the NGPA, and pre-granted abandonment authority for transported gas;
- Establish rate principles for non-discriminatory access, including reservation charges for firm service and downwardly flexible, cost-of-service rates for transportation;
- Require that firm sales customers can be allowed the opportunity to convert their contract sales demands to transportation;
- Provide for a transition from existing programs to the new programs;
- Provide expedited certificates for new facilities needed for transportation.

Order No. 436 revokes Section 157.209 and amends Part 284 to prohibit explicitly unduly discriminatory or preferential practices under blanket certificates and self-implementing transportation.¹⁷⁰ Thus, if a pipeline wants to provide any type of new, self-implementing transportation after November 1, 1985, it must offer such transportation to all potential customers on a non-discriminatory basis. Discrimination among customer classes—on the basis of volume requirements, the quality and duration of service, the end-use of gas or the type of gas transported—is explicitly prohibited.

The old blanket certificate programs are replaced by (a) self-implementing transportation requiring no prior Commission approval, and (b) a new blanket certificate program. Self-implementing transportation may be undertaken by an interstate pipeline on behalf of any intrastate pipeline or any LDC, subject to the rate and open access requirements of the new rules.¹⁷¹ Self-implementing transportation may also be undertaken by an intrastate pipeline on behalf of any interstate pipeline or LDC served by an interstate pipeline, subject to FERC open access standards.¹⁷² Blanket certificates will be issued to interstate pipelines upon application for transportation "on behalf of others" if the pipeline agrees to comply with the rate and open access requirements.¹⁷³ Shortened hearing procedures are used if there is no protest,¹⁷⁴ and inquiry into whether

168. Order No. 436, *supra* note 1, at 42,411. See also *Tennessee Gas Pipeline Co.*, 21 F.E.R.C. ¶ 61,004 (1984); *Columbia Gas Transmission Corp.*, 26 F.E.R.C. ¶ 61,034 (1984).

169. Order No. 436, *supra* note 1, at 42,413-14.

170. Subpart G, §§ 284.8(b), 248.9(b), 284.221(c)(1), 50 Fed. Reg. 42,493-98 (1985) (to be codified at 18 C.F.R. §§ 284.8(b), 284.221(c)(1)).

171. *Id.* at § 284.102.

172. *Id.* at § 284.122. Intrastate pipelines are exempted from the rule's rate requirements, CD conversion requirements, and obligation to provide both firm and interruptible service. Order No. 436, *supra* note 1, at 42,426.

173. Subpart G, at § 284.221.

174. Subpart E, § 157.104(b), 50 Fed. Reg. 42,489 (1985) (to be codified at 18 C.F.R. § 157.104).

such transportation would be for the public convenience and necessity is precluded.¹⁷⁵

Transportation for any end-user for a period of 120 days is authorized without prior notice if a pipeline has a blanket certificate under Section 284.221. Subject to prior notice, which requires identification of the shipper, the contract and volumes of gas involved, and subject to possible protest and hearings, transportation for shippers other than pipelines may be granted for any duration.¹⁷⁶

Order No. 436 changes the rate structure for transportation by doing away with the credit-to-cost-of-service approach and allowing the charging of rates based on projected costs for transportation plus a return on invested capital.¹⁷⁷ The Commission concluded that the credit approach of prior programs provided an insufficient incentive to encourage pipelines to offer transportation.¹⁷⁸ Interstate pipelines may now establish a maximum and minimum rate, allowing rates to change over the specified range without further Commission review.¹⁷⁹ Rates can recognize quality of service by requiring a reservation fee for firm service. Rates must be time-of-use differentiated, one-part, volumetric, and may not include any minimum bill.¹⁸⁰

Core customers are expressly included. Existing firm sales customers have the option of reducing their firm contract demand (CD) by a specified amount and converting to transportation, but the CD conversion right can only be triggered by an interstate pipeline's decision to provide open access transportation.¹⁸¹ Pre-granted abandonment for such conversions is available.¹⁸² New firm sales customers will not be entitled to any conversion rights unless the pipeline voluntarily provides such rights in its tariff. In responding to comments on the CD conversion rights, the Commission reasoned that it was not abrogating firm sales contracts. Rather, a pipeline's voluntary decision to participate in open access transportation carries with it a voluntary agreement to adjust firm sales contracts.¹⁸³

All types of transportation are covered, including back-hauls, exchanges, displacement, and contract storage.¹⁸⁴ Both firms and interruptible service must be offered by interstate pipelines, subject to available capacity.¹⁸⁵ Capacity must be allocated on a "first-come, first-served" basis.¹⁸⁶ "First-come" is defined as when a customer requests service, not the time at which a contract for transport-

175. Subpart G, *supra* note 170, at § 284.221(a).

176. *Id.* at §§ 284.223(b),(c).

177. *Id.* at §§ 284.7(c), 284.8(c), 284.8(d) and 284.9(d).

178. Order No. 436, *supra* note 1, at 42,421.

179. Subpart G, *supra* note 170, at §§ 284.7(d)(5), § 284.8(d). Intrastate pipelines are not subjected to the new rate conditions.

180. *Id.* at § 284.7(c),(d).

181. *Id.* at § 284.10(d). CD demand may also reduced without converting to transportation.

182. *Id.* at § 284.10(f).

183. Order No. 436-A, *supra* note 1, at 52,237-38.

184. Order No. 436, *supra* note 1, at 42,431-32.

185. *Id.* at 42,425, 42,435-36. Subpart G, *supra* note 170, at §§ 284.8(e), .9(a). Intrastate pipelines, however, may limit the service offered to either interruptible or firm service.

186. Order No. 436, *supra* note 1, at 42,437-38.

tation is executed.¹⁸⁷ And if capacity must be curtailed, "last-on, first-off" does not apply.¹⁸⁸

On the issue of cost-shifting caused by conversions, the Commission noted the problem and concluded that the benefits of improved access to the gas market outweighed the detriment of cost-shifting between customers who convert and those who do not. The Commission promised to review this issue in individual rate cases.¹⁸⁹ The Commission also noted that conversion is a two-way street. Once a firm sales customer converts, it has no right to swing the converted load back onto the pipeline unless the pipeline confers such a right through a stand-by charge.¹⁹⁰ The pipeline may file for abandonment of the converted load.

Grandfathering of existing transportation is provided. Existing section 311 arrangements commenced prior to October 9, 1985, can continue until the expiration of their original term or October 31, 1987, whichever is earlier. Blanket transportation for high priority end-users initiated prior to October 9, 1985, under section 157.209(a), may continue according to the terms under which it was initiated if the new rate standards are complied with.¹⁹¹ However, transportation for lower priority end-users under section 157.209(e) initiated prior to October 9, 1985 was allowed to continue from November 1, 1985 until December 15, 1985 only if the pipeline agreed to the non-discriminatory access condition for the transitional period.¹⁹² Accordingly, section 157.209(e) transportation died a natural death on October 31, 1985, along with the SMP program. New section 311 transportation may be commenced or continued through June 30, 1986 without triggering the firm sales conversion provisions, a concession allowed in order to avoid disrupting the winter peak season, but open access must be provided during the transition period.¹⁹³

Other transition provisions include a phase-in for CD conversions and temporary rates. As modified by Order No. 436-A, a particular customer may convert no more than fifteen percent of his volumetric takes in the first twelve-month period after the transition period if the CD conversion is triggered.¹⁹⁴ In the subsequent four twelve-month periods, the customer can convert up to 30%, 50%, 75% and 100% respectively.¹⁹⁵ Previously filed rates for blanket certificates, and existing rates for self-implementing transportation, may be used temporarily, but new cost-based rates must be filed to take effect by July 1,

187. Order No. 436-A, *supra* note 1, at 52,250.

188. *Id.* at 52,231.

189. Order No. 436, *supra*, at 42,441-42.

190. *Id.* at 42,443.

191. Subpart G, *supra*, note 170, at § 284.223(g)(1).

192. *Id.* Order No. 436-A extended the December 15, 1985 deadline to December 16, 1985.

193. Originally, the transition period was to end December 15, 1985, but it was expanded for section 311 transportation to February 15, 1986, Order No. 436-A, *supra* note 1, at 52,229, and then to June 30, 1986, to allow time for negotiation between pipelines and their customers. Order No. 436-B, *supra* note 1.

194. Subpart G (as revised by Order No. 436-A), § 284.10(c)(3), 50 Fed. Reg. 52,275 (Dec. 23, 1985). Because 45 days notice is required, followed by 150 days delay before CD conversion takes effect, conversions cannot actually be implemented until 195 days after February 15, 1986, at the earliest, if a pipeline implements open access transportation on that date. *Id.* at 52,241.

195. *Id.* at § 284.10(d).

1986.¹⁹⁶

To lower barriers to competition, the Commission in Order No. 436, adopted expedited procedures for new facilities. Under Sections 157.102 and 157.103, new facilities can be authorized without a certificate upon the mere filing of an application. If no protest is filed, no hearings are required, and if a protest is filed, a presumption that the application would be consistent with public convenience and necessity is applied in expedited hearings.¹⁹⁷ The purpose of the rule is to encourage construction of service taps so that buyers can be served by more than one pipeline.¹⁹⁸

The rationale for allowing the expedited certificate procedure is the pipeline's assumption of risk. If the new facilities are not as successful as hoped, the pipeline cannot then reallocate the costs to its other customers.¹⁹⁹ Rates for the new service must reflect the cost of that service, and the rates may not later be reduced beyond the specified minimum. Rates may be varied over a range with a cost-based maximum and a minimum based on average variable costs allocable to the service.²⁰⁰ The new service may be a transportation service, or it may be a new sales service.²⁰¹

It has long been argued that the Commission lacks authority to require that pipelines provide contract carriage. The argument is based on legislative history of the Natural Gas Act indicating that gas pipelines were not to be made common carriers.²⁰² In Order No. 436, the Commission avoided this problem by making the non-discriminatory access condition voluntary. That is, if a pipeline chooses to provide no transportation services under blanket authority, or only to continue pre-existing services for the grandfathered period, then non-discriminatory access need not be provided.²⁰³ The Commission preserved the argument, however, that an order compelling transportation may be an appropriate remedy for anti-competitive or unduly discriminatory conduct.²⁰⁴

The Commission stated that it had not extended the non-discriminatory access requirement in advance to section 7 certificate proceedings, but that it would scrutinize arrangements in advance on a case-by-case basis.²⁰⁵ Also, once a pipeline has accepted a blanket certificate, it may withdraw from the service and return to the role of a merchant only, and thereby be released from the requirement of providing non-discriminatory access.²⁰⁶

In *ANR Pipeline Co.*, issued on October 31, 1985, the Commission indi-

196. Subpart G, *supra* note 170, at § 284.7(b).

197. Subpart E, §§ 157.102, 157.103, 157.11, 50 Fed. Reg. 42,488-9 (1985) (to be codified at 18 C.F.R. §§ 157.102, 157.103, 157.11).

198. Order No. 436, *supra* note 1, at 42,467.

199. *Id.* at 42,472.

200. *Id.*

201. Subpart E, *supra* at § 175.101(a)(2).

202. See Mogel and Gregg, *supra* note 36, at 168-172.

203. Order No. 436, *supra*, note 1, at 42,427-28. The Commission in a clarifying order indicated that a commitment to provide open access for the transition period beginning November 1, 1985, does not bind a pipeline beyond the end of the transition period. See Order No. 436-A, *supra* note 1, at 52,220.

204. *Id.*; See *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973); *MPC I*, 761 F.2d 768 (D.C. Cir. 1984); *Niagara Mohawk Power Co. v. FPC*, 379 F.2d 153, 159 (D.C. Cir. 1967).

205. Order No. 436, *supra* note 1, at 42,435.

206. *Id.* at 42,434.

cated that it will not allow pipelines to subvert the intent of Order No. 436 by seeking authorization in separate section 7 proceedings: "[w]hile conventional section 7(c) certificate applications may continue to be filed, the effectiveness of the new rule and the underlying rationale require the Commission to assure that it will not be permitting undue discrimination to be perpetrated, or perpetuated, by the individual consideration of separate certificate applications."²⁰⁷ Hence, despite ruling in Order No. 436 that the new rule would not apply to section 7 proceedings, FERC apparently intends to apply the non-discriminatory standard in section 7 proceedings.²⁰⁸

The Commission's new transportation initiative was not initially well received by the pipelines. The Commission observed that its proposal on transportation was opposed by a majority of pipelines that submitted comments in the rulemaking.²⁰⁹ Nine pipelines agreed to continue transportation authorized under section 157.209(e) for the interim period of November 1, 1985 to December 15, 1985, subject to the open access provision.²¹⁰ Only four pipelines agreed to provide open access transportation after the transition period.²¹¹ Seven have stated unequivocally that they would not become open transporters.²¹² However, in Order No. 436-B, the Commission observed that nine pipelines had applied for blanket certificates under Order No. 436 and that negotiations were underway that would lead to wider participation in the Order No. 436 program.²¹³

The reluctance of pipelines to participate in the new transportation program will have a serious impact on producers. While LTAs have replaced SMPs to free up gas for the spot market, transportation arrangements under Order 436 must be made in order to market this gas. Without widespread participation by the pipeline industry, many producers may be shut-in or left with no way to transport their gas to willing sellers.

Pipelines, on the other hand, will be hard pressed to justify refusals to provide transportation. In theory, the new transportation program is not all that new. The requirement to provide service without undue discrimination or preference has existed since 1938 when the Natural Gas Act was passed and, arguably, prior to that time under the Sherman Antitrust Act.²¹⁴ Companies

207. *ANR Pipeline*, 33 F.E.R.C. ¶ 61,149 at 61,324 (1985).

208. The Commission in Order No. 436-A stated that the *ANR* decision did nothing more than set the non-discriminatory transportation issues for hearing. 50 Fed. Reg. at 52,237.

209. Order No. 436, *supra* note 1, at 42,426.

210. *ANR Pipeline Co.*, *Arkla Energy Resources*, *Columbia Gas Transmission Corp.*, *Columbia Gulf Transmission Co.*, *Mid-Louisiana Gas Co.*, *Northern Natural Gas Co.*, *Northwest Pipeline Corp.*, *INSIDE FERC*, (McGraw-Hill) 4-5 (Nov. 4, 1985); *Texas Eastern Transmission Corp.*, *Colorado Interstate Gas Co.*, *INSIDE FERC* (McGraw-Hill) 1 (Nov. 11, 1985).

211. *Columbia Gas Transmission Corp.* and *Columbia Gulf Transmission Co.* were the first to sign-up for open access transportation authority. *Transwestern Pipeline Co.* and *El Paso Natural Gas Co.* joined the *Columbia* systems in January. 84 *OIL & GAS J.* No. 4, p. 49 (Jan. 27, 1986). *Mid-Louisiana Gas Co.* has indicated it will offer open access transportation. *INSIDE FERC* (McGraw-Hill) 1 (Nov. 11, 1985).

212. *Natural Gas Pipeline Co. of America*, *Panhandle Eastern Pipe Line Co.*, *Southern Natural Gas Co.*, *Tennessee Gas Pipeline Co.*, *Transcontinental Gas Pipe Line Corp.*, *Trunkline Gas Co.*, *United Gas Pipe Line Co.*, *INSIDE FERC* (McGraw-Hill) 4-5 (Nov. 4, 1985).

213. Order No. 436-B, *supra* note 1.

214. Undue preference or discrimination is precluded by the Natural Gas Act, 15 U.S.C. § 717c(b), 717d (1982). The Sherman Act is codified at 15 U.S.C. §§ 1-7 (1982).

that now withdraw from the transportation market solely because of a non-discriminatory basis are making a statement that they prefer to act discriminatorily. Producers and buyers have a sound claim that pipelines' refusals to provide transportation service are violative of the Natural Gas Act and the Sherman Antitrust Act.²¹⁵

In the past, few cases were brought against pipelines for refusals to provide transportation. There are only two reported decisions under the antitrust laws on this point.²¹⁶ As a result of pipelines' declared refusals to provide non-discriminatory transportation, there may well be others. At least five antitrust cases brought by shippers and producers against pipelines for denying transportation access were pending in early 1985.²¹⁷ Recently, the Federal Trade Commission and an Oklahoma independent producers group have urged the Department of Justice to investigate pipelines' refusals to allow access for transportation.²¹⁸ With the possibility of obtaining treble damages for violations of the antitrust laws, additional private suits are sure to be filed.

V. CONCLUSION

FERC has been confronted with seemingly contradictory objectives. On the one hand, it is responding to a Congressional determination to deregulate the cost of gas, while on the other hand retaining regulation of the price of old gas and of interstate transportation and sales for resale. As part of its deregulation mandate, FERC is unbundling gas costs from the fixed costs of providing service, with the hope that unbundling will improve the transmission of price signals from the burner-tip to the wellhead and vice versa. In addition, in response to judicial mandates and as part of its effort to improve the marketability of gas, FERC is pushing pipelines to provide open access to their transportation systems. These efforts, it is hoped, will inject competition into a previously monopolized market so that the laws of supply and demand can more efficiently allocate the resources of the industry.

It is too early to tell how successful these efforts will be. It is possible that market restructuring will subject producers to oscillations in demand that are not consistent with the requirements of the production industry. Oil and gas production requires long-term commitments at stable production rates to avoid wasting the natural resource and altering correlative rights, factors favoring retention of the pipelines' traditional role. Consumers also may again face curtailments or supply interruptions as LDCs reduce firm contract commitments to go shopping for cheaper gas. Pipelines and LDCs, operating in a competitive environment, will face the risk of lost earnings, and possibly even bankruptcy,

215. See *Mahinka and Johnson*, New Antitrust Issues in a Deregulated Environment: Access to Pipelines, 4 ENERGY L.J. 211 (1983); Reiter, Competition and Access to the Bottleneck: The Scope of Contract Carrier Regulation Under the Federal Power and Natural Gas Acts, 18 LAND & WATER L. REV. 1 (1983).

216. *Venture Technology, Inc. v. National Fuel Gas Co.*, 1980-81 Trade Cas. (CCH) ¶ 63,780 (W.D. N.Y. 1981), *rev'd*, 685 F.2d 41 (2d Cir. 1982), *cert. denied*, 459 U.S. 1007 (1982); *Woods Exploration and Producing Co. v. Aluminum Co. of Am.*, 438 F.2d 1286 (5th Cir. 1971), *cert. denied*, 404 U.S. 1047 (1972).

217. See Report of the Comm. on Antitrust, 6 ENERGY L.J. 83, 94-95 (1985).

218. *INSIDE FERC* (McGraw-Hill) 3 (Nov. 18, 1985); 13 ENERGY USERS REP. (BNA) 1179 (Nov. 14, 1985).

if their business judgments are poor.

It is also possible that the new approach will work. Most agree that the supply shortages experienced in the 1970s and the supply surplus of the 1980s are indications that the existing system was inadequate and that market restructuring was necessary. FERC will continue to regulate segments of the industry and will be available to respond to claims that market restructuring is not working as intended. The Commission's response to the *MPC* cases shows how its pro-deregulation policy can be adjusted to accommodate more traditional concerns of public utility regulation.

