

## THE REGULATION AND FUTURE ROLE OF DIRECT PRODUCER SALES

Robert C. Means\*  
Robert S. Angyal\*\*

Most natural gas is bought and sold by at least one pipeline before reaching the consumer. In the interstate market, more than ninety percent of the gas is sold by pipelines to distributors. Until recently, virtually all the rest was sold directly by pipelines to large industrial and utility customers.<sup>1</sup> Direct sales by producers to end-users or distributors were a rarity in the interstate market; they were more common in the intrastate market but were still the exception.<sup>2</sup>

Even today, such natural gas sales — commonly called "direct producer sales" — account for only a small fraction of total sales,<sup>3</sup> but their importance has been growing. There are two reasons for their growth. One is economic: For producers, direct sales may be the only outlet for their gas; for customers, gas can in some cases be purchased more cheaply from a producer than from pipeline system supply; for pipelines, the alternative to transporting producers' direct sale gas may be to lose markets altogether.

The economic reason alone is sufficient to explain the growth of direct producer sales in the intrastate market, where pipelines generally are only lightly regulated. In the interstate market, legal changes have been a second necessary cause. Federal regulation would once have constituted a substantial barrier to direct producer sales even where the transaction served the interests of the parties and the transporting pipeline. Over the past decade, however, the burden of federal regulation has been substantially reduced by the creation of legal rules that allow many direct producer sales to be made without prior administrative approval.

The legal rules are not simple. They are only in part a reflection of current policies relating to direct producer sales. In large part they are a product of the history of efforts to deal with other problems. The result is a set of rules that may encompass most commercially significant transactions but that does so through the accumulation of a number of distinct categories.

\*B.S., Iowa State University, 1960; LL.B., *magna cum laude*, Harvard Law School, 1964; S.J.D., Harvard Law School, 1977; Adjunct Professor, The Washington College of Law, American University; Vice President, Swanson Energy Group, Inc., Boston, Mass. and Washington, D.C. Former Director, Office of Regulatory Analysis, Federal Energy Regulatory Commission, Washington, D.C.

\*\*B.A., University of Sydney (Australia), 1971; LL.B., (first-class honors), University of Sydney Law School, 1974; LL.M., Yale Law School, 1975; Member of the District of Columbia and New South Wales (Australia) Bars; Acting Assistant Director, Office of Regulatory Analysis, Federal Energy Regulatory Commission, Washington, D.C.

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<sup>1</sup>Direct sales by interstate pipelines to ultimate consumers equal approximately 1 trillion cubic feet ("Tcf") out of total annual interstate pipeline sales of approximately 12 Tcf.

<sup>2</sup>In 1978, direct producer sales accounted for about 35 percent of total intrastate sales. See Energy Information Administration, *Intrastate and Interstate Supply Markets Under the Natural Gas Policy Act* 10 (1981). However, this figure probably overstates the importance of direct producer sales in the intrastate market at that time. Many of the sales evidently had been negotiated some years in the past, a fact reflected in the low average price of the direct sales. In addition, it appears that many of the "sales" were in fact transactions between corporate affiliates, for example, between an oil company and its affiliated petrochemical company.

<sup>3</sup>According to one knowledgeable observer, spot sales — presumably mostly direct producer sales — were being made at an annual rate of 500 billion cubic feet ("Bcf") to 1 Tcf in late 1983. INSIDE FERC, Jan. 9, 1984 at 1 (quoting Benjamin Schlesinger.) For that estimate, spot sales were defined to include both sales under 30-day to six-month contracts and sales under longer-term contracts with provisions for frequent price adjustments.

One purpose of this article is to outline these rules. Its second purpose is to assess the longer-term significance of direct producer sales. Their potential significance is very large: A gas industry in which most or even much of the gas supply was sold directly by producers would be a very different industry from the present one. Whether that potential will be realized, however, is far from certain.

The economic basis for the recent growth in direct producer sales has been in substantial part the result of transitory market conditions — the natural gas surplus and the rigidity of the price terms in producer-pipeline contracts. Whether direct producer sales will continue to grow in the future, or even maintain their present importance, depends not only on the further development of legal rules and regulatory policies, but also on the economic role that those sales can play in a world of flexible producer-pipeline contracts and reasonable supply-demand balance.

This article is concerned solely with direct producer sales in the interstate market. This is a significant limitation. Such sales have been, as already noted, more common in the intrastate market than in the interstate market. The limitation is an accommodation to the availability of data. One of the by-products of regulation — fortunate or unfortunate according to one's tastes and needs — is voluminous information. The information gathered often is not precisely the information one wants, but we do know a great deal about the regulated interstate market, and very little about the unregulated intrastate one.

## I. THE LEGAL FRAMEWORK

A direct producer sale does not bypass pipelines in a physical sense. There is no practical alternative to pipelines for the overland transportation of natural gas. Gas in a direct producer sale, like gas in any other sale, is carried by a pipeline most of the distance from wellhead to burnertip. A direct producer sale does bypass pipelines in a legal sense. A pipeline carries the gas but does not own it. A direct producer sale will be defined here as one in which the gas reaches the ultimate consumer without ever having been purchased by a pipeline. The producer may sell his gas to the end user or to a distributor or independent marketer; but he does not sell it to a pipeline.<sup>4</sup>

The distinction between direct producer sales and other sales is thus a matter of legal form. It is, however, a matter of form that has major implications for both the regulation and economic function of the two kinds of sales.

### A. *Historical Development*

The legal rules governing direct producer sales in the interstate market once were simple in terms and in result. Before 1975 they were for the most part limited to the provisions of section 7 of the Natural Gas Act.<sup>5</sup> The Federal Power Commission generally used those provisions to effectively bar direct producer sales in the interstate market.

<sup>4</sup>For purposes of this article, an "independent marketer" is a party other than a pipeline or distributor that buys and resells gas. An independent marketer differs from a marketer in that an independent marketer takes title to the gas. The distinction between a pipeline and a distribution company is not clear in all cases. Some pipelines also operate distribution grids, and some companies that are considered to be distribution companies operate transmission lines to link separate distribution grids or to carry gas from a pipeline to the distribution grid.

<sup>5</sup>Natural Gas Act ("NGA") § 7, 15 U.S.C. § 717f (1982).

The provisions of section 7 potentially touch on direct producer sales at three points. One is regulation of the sale itself. Before *Phillips*<sup>6</sup> in 1954, producer sales, whether direct or to a pipeline, were themselves not regulated. Therefore, producer sales were not regulated if made directly to an end user. Such sales are not sales for resale, and therefore do not fall under federal jurisdiction. But interstate producer sales to distributors were subject to the same legal principles as sales to interstate pipelines. Because they were sales in interstate commerce for resale, they were jurisdictional sales under the Natural Gas Act and therefore required a certificate under section 7(c).<sup>7</sup>

*Phillips* had further implications. If a producer sale to an interstate pipeline was a jurisdictional sale, it could not be halted simply because the sales contract expired or the parties agreed to terminate it. In legal theory, if not in practical fact, *Phillips* converted natural gas producers into public utilities. A producer could not abandon service to the purchasing pipeline unless authorized to do so by the Commission under section 7(b),<sup>8</sup> and after a natural gas shortage developed in the interstate market in the early 1970's, abandonment was virtually never authorized.<sup>9</sup> As a practical matter, therefore, reserves that had once been committed to an interstate pipeline were henceforth not available for sale to other pipelines, or for direct sale by the producer.

Thus, direct producer sales to distributors and sales to anyone of gas previously committed to an interstate pipeline could not be made without prior Commission approval. The sales that remained — sales to end-users of uncommitted gas — could in theory be made free of any federal regulation. A sale was of no value, however, unless the gas could be moved to the purchaser, and all interstate transportation of natural gas — whether sold to an end-user or for resale — was subject to Commission regulation and required a section 7 certificate.<sup>10</sup> This broad transportation jurisdiction allowed the Commission to impose a de facto regulation on all sales in interstate commerce, and at least after 1959, the Commission generally used this power to ensure that gas sales in the interstate market moved only through

<sup>6</sup>*Phillips Petroleum Corp. v. Wisconsin*, 347 U.S. 672 (1954) (holding that the NGA required Commission rate regulation of natural gas sales by independent producers).

<sup>7</sup>NGA § 1(b), 15 U.S.C. § 717(b) (1982), states that the NGA applies, *inter alia*, "to the sale in interstate commerce of natural gas for resale." NGA § 7(c)(1)(A), 15 U.S.C. § 717f(c)(1)(A) (1982), forbids any jurisdictional sale of natural gas unless there is in force a certificate of public convenience and necessity issued by the Commission authorizing the sale.

<sup>8</sup>NGA § 7(b), 15 U.S.C. § 717f(b) (1982), forbids the abandonment of any jurisdictional service without the prior permission of the Commission.

<sup>9</sup>See generally Conine & Niebrugge, *Dedication Under the Natural Gas Act: Extent and Escape*, 30 Okla. L. Rev. 735, 772-806 (1977).

<sup>10</sup>NGA § 1(b), 15 U.S.C. § 717(b) (1982), states that the NGA applies, *inter alia*, "to the transportation of natural gas in interstate commerce." Section 7(c)(1)(A) of the NGA, 15 U.S.C. § 717f(c)(1)(A) (1982), forbids any jurisdictional transportation of natural gas unless there is in force a certificate of public convenience and necessity issued by the Commission authorizing the transportation.

established channels.<sup>11</sup> Its primary reason for doing so was that, since it could not regulate the price paid in a direct sale, it feared that direct purchasers prepared to pay prices higher than those allowed in Commission-regulated sales would attract gas suppliers away from the interstate pipelines and generally bid up the field price of gas.<sup>12</sup> The courts affirmed the Commission in its use of its power over transportation to prevent direct sales.<sup>13</sup>

Even if the Commission had looked more favorably on direct producer sales, however, the mere fact that as many as three certificates could be required for an interstate sale would itself have been a substantial obstacle. It might have been

<sup>11</sup>Before its 1959 *Transco* decision, *infra* note 12, the Commission had on occasion issued certificates authorizing transportation to direct purchasers where there were strong reasons for doing so. See, e.g., *Houston Texas Gas & Oil Corp.*, 16 FPC 118, 122-23 (1956) (certificating transportation — amounting to 60% of the capacity of a proposed pipeline to Florida — for gas sold in direct producer sale to Florida Power & Light Co. and Florida Power Corp. for generating electricity, on grounds that Florida was almost totally dependent on imported energy, chiefly oil and that, because of the state's mild climate, a large part of the market there for gas consisted of sales to power companies for generating electricity); *Northern Natural Gas Co.*, 15 FPC 1634 (1956) (certificating transportation for direct sale to Northern States Power Co. for generating electricity on grounds that the interruptible service would materially improve the pipeline's load factor and also yield substantial revenues which might lower rates charged to pipeline's existing customers).

After its *Transco* decision, *infra* note 12, there continued to be one exception to the Commission's general policy against certificating transportation of gas sold in a direct producer sale. That was the "Chandeleur incentive," a policy of allowing pipelines to transport portions of offshore Federal domain gas reserves which producers had reserved for their own use or that of affiliated companies, primarily for such relatively low-priority uses as boiler fuel in refineries. The Chandeleur initiative's primary justification was the theory that the resulting availability of cheap gas as refinery boiler fuel would spur refining of oil, thus creating a need to explore for more oil, and thus perhaps leading to the discovery of larger new reserves of gas (often located near reserves of oil) than would be needed for consumption in the refineries. *Chandeleur Pipe Line Co.*, Opinion No. 560, 42 FPC 20 (1969), *remanded*, Pub. Serv. Comm. of New York v. FPC, 436 F.2d 904 (D.C. Cir. 1970), *on remand*, *Chandeleur Pipe Line Co.*, Opinion No. 560-A, 44 FPC 1747 (1970), *aff'd*, Pub. Serv. Comm. of New York v. FPC, 463 F.2d 824 (D.C. Cir. 1974).

In 1977, the Commission terminated the Chandeleur incentive, but agreed to allow transportation of producer-reserved gas from the offshore Federal domain for use by a company affiliated with the producer, or for direct sale to specified industrial end-users. The producers reserved up to 50% of the gas produced. The bulk of the producer-reserved gas was to be used as a feedstock in the manufacture of anhydrous ammonia for fertilizer. The Commission's justification was that natural gas was a feedstock for ammonia production, and therefore this was a high-priority use. Further, the importance of ammonia-based fertilizer in food and fiber production, coupled with projections of fertilizer shortages, supported agreeing to the producer reservations and certificating the transportation. *Tenneco Oil Co.*, Opinion No. 789, 57 FPC 1306 (1977). But in 1978, the Commission largely reversed its position, and refused to allow transportation, finding that to do so would conflict with its policy on transportation for direct producer sales enunciated in Order No. 533 (discussed *infra* text at note 14), which specifically excluded from eligibility for transportation gas from the offshore Federal domain. Further, the Commission found that agreeing to offshore producer reservations would also conflict with Opinion No. 533 by creating a "preferred class of industrial customer" — those with access to the reserved gas. *Tenneco Oil Co.*, Opinion No. 10, 2 FERC ¶ 61,247 at 61,559 (1978), *reh. granted in part and denied in part*, Opinion No. 10-A, 3 FERC ¶ 61,258 (1978). On appeal, however, the Fifth Circuit vacated and remanded Opinion No. 10. *Air Products & Chemicals, Inc. v. FERC*, 650 F.2d 687 (5th Cir. 1981). On remand, the Commission agreed to consider new applications for transportation of producer-reserved gas. *Tenneco Oil Co.*, Opinion No. 10-B, 21 FERC ¶ 61,320 (1982).

<sup>12</sup>*Transcontinental Gas Pipe Line Corp.*, 21 FPC 138 (1959) (denying certificate for transportation of 44 billion cubic feet per year of gas to be sold in direct producer sale to Consolidated Edison Co. for generating electricity).

<sup>13</sup>*FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1 (1961), *affirming* *Transcontinental Gas Pipe Line Corp.*, 21 FPC 138 (1959) and *reversing* 271 F.2d 942 (3d Cir. 1959); *Arizona Public Service Comm. v. FPC*, 483 F.2d 1275 (D.C. Cir. 1975), *remanding* *El Paso Natural Gas Co.*, 47 FPC 896 (1972) (affirming Commission on denial of certificate but remanding for consideration of environmental consequences), *on remand*, 50 FPC 1264 (1973), *affirmed*, 490 F.2d 783 (1974); *Southern California Edison Co. v. FPC*, 387 F.2d 619 (3d Cir. 1967) (*per curiam*) (affirming *Transwestern Pipeline Co.*, 36 FPC 176 (1966)), *cert. denied*, 392 U.S. 909 (1968).

worthwhile to overcome the obstacle if the sale were large and long-term, but the burden and delay of obtaining individual certificates probably would have foreclosed short-term sales regardless of the Commission's substantive policies.

In the mid-seventies, federal gas regulation began to change in ways that facilitated direct producer sales. The changes were of two kinds. One was substantive. The Commission abandoned its general opposition to interstate direct producer sales. Opposition initially was replaced by a somewhat grudging acceptance of such sales as a necessary evil, but by 1982 they were viewed, with some qualifications, as a legitimate part of more open and competitive natural gas markets. The second change was procedural. For many sales, the slow process of obtaining individual section 7 certificates was replaced by procedures that allowed sales to be made without prior Commission approval. Interstate transportation continued to be subject to federal regulation, but for transactions qualifying for the new procedures, compliance with those regulations no longer delayed the sale past the point of commercial relevance.

#### 1. 1975-1979

##### a. *The Order No. 533/Order No. 2 program.*

The policy shift began with Order No. 533<sup>14</sup> issued in 1975. In that order, the Commission performed a striking about-face. As noted above, it had earlier generally refused to allow pipelines to transport gas sold directly by producers to end-users. The Commission opposed such transactions because it had no control over the price. Since some end-users were willing to pay more than the just and reasonable rate set by the Commission for sales for resale,<sup>15</sup> the FPC feared that widespread direct sales would attract gas away from sales to interstate pipelines, and also "lever upwards" field prices for all gas.<sup>16</sup> By denying transportation certificates, the Commission had deliberately shut off one avenue for price competition for gas not already dedicated to the interstate market.

It therefore is not without some irony that Order No. 533, the first of the Commission's general programs to provide transportation for end-users, was justified as a way of allowing price competition in order to attract additional gas for interstate pipelines' customers. The Commission was faced by "the steady increase in curtailment levels on interstate pipelines which resulted in production cutbacks, plant closings, employee layoffs, and shortages of various products and services."<sup>17</sup> It therefore determined, on an experimental basis, to allow high-priority end-users served by interstate pipelines to compete on the basis of price for access to unregulated intrastate gas:

<sup>14</sup>Policy with Respect to Certification of Pipeline Transportation Agreements, Docket No. RM75-25, Order No. 533, 54 FPC 521 (1975), 40 Fed. Reg. 41760, *reh. granted in part and denied in part*, Order No. 533-A, 54 FPC 2058, 40 Fed. Reg. 54724 (1975) (codified at 18 C.F.R. § 2.79), *aff'd*, American Public Gas Ass'n v. FERC, 587 F.2d 1089 (D.C. Cir. 1978).

<sup>15</sup>Upholding a Commission refusal to certificate transportation for a direct sale, the Supreme Court noted that the Commission had recently set field prices for sales for resale in the relevant area at 18 cents per thousand cubic feet ("Mcf"). The direct sale price that had been agreed on was 19¼ cents per Mcf. FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. at 23 n. 18.

<sup>16</sup>*Id.* at 23.

<sup>17</sup>Amendments to Policy Regarding Certification of Pipeline Transportation Agreements, Docket No. RM75-25, Order No. 2, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,005 at 30,019, 43 Fed. Reg. 5362 (1978) (explaining motivation for Order No. 533 in context of continuing and expanding the program), *clarified*, Order No. 2-A, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,303 (1978), 46 Fed. Reg. 53651 (1981).

Because . . . direct sales would not be subject to our rate jurisdiction, high priority customers could compete with the producer's intrastate customers for gas supplies not otherwise available to the interstate market.<sup>18</sup>

The Commission's inability to regulate the price paid by direct purchasers was, in other words, now seen as a distinct advantage. The District of Columbia Circuit affirmed the Commission's plan as "a legitimate, experimental approach for dealing with the inherently skewed nature of our half-free [natural gas] market."<sup>19</sup>

Order No. 533 did not itself authorize individual transactions. It was simply a policy statement to the effect that the national interest in the protection of gas service to customers using it for high-priority uses would be served by Commission approval of applications for certificates by pipelines to transport gas sold by producers directly to such customers.<sup>20</sup> Before undertaking a particular transaction, a pipeline had to obtain a Commission certificate authorizing the transportation required.

And the program was quite limited in scope. The customers had to be existing industrial or large commercial customers using gas for commercial, feedstock, or process purposes, and whose supplier pipeline were either in, or subject to, imminent curtailment.<sup>21</sup> There were also strict limits on the volume of gas an end-user could directly buy,<sup>22</sup> and the maximum term of any certificate was two years.<sup>23</sup>

After reviewing the results of this experimental program, the FERC decided to continue it in Order No. 2, issued in 1978.<sup>24</sup> The Commission noted that, through November 1977, it had issued certificates for transportation of a total of 15.8 Bcf, and that most Order No. 533 sales had been made at rates above the nationwide rate set by the Commission for sales for resale.<sup>25</sup> Indeed, for 30 of 38 certificates issued after April 1, 1977, the price paid the producer exceeded \$1.74 per Mcf,<sup>26</sup> at a time when the national base rate for the newest gas was \$1.42.<sup>27</sup> For 15 of these arrangements, the price exceeded \$1.99.<sup>28</sup> At these prices, the Commission recognized, interstate pipelines could not compete for supplies.<sup>29</sup>

<sup>18</sup>Order No. 533, 54 FPC at 823. One Commissioner, dissenting from the issuance of Order No. 533, labelled the policy "an attempt by the Commission to deregulate the price of natural gas at the production level when sold in interstate commerce." *Id.* at 846 (Commissioner Springer, dissenting). He continued:

What we are indicating in this policy statement is that someone who desires to purchase natural gas may go into the field or to an intrastate seller and pay whatever price the market will bear, and transport it through an interstate pipeline. This is exactly what the Natural Gas Act . . . was intended to prevent . . .

*Id.* at 846-47.

<sup>19</sup>American Public Gas Ass'n v. FERC, 587 F.2d at 1098. By enacting Section 608 of the Public Utility Regulatory Policies Act of 1978, ("PURPA"), 15 U.S.C. § 717f(c)(2) (1982), Congress amended the Natural Gas Act with the intention of removing any doubts as to the Commission's power to certificate transportation of gas bought by end-users in direct sales for high-priority end-uses. H.R. Conf. Rep. No. 1750, 95th Cong., 2d Sess. (1978), reprinted in 1 FERC Stat. & Reg. ¶ 5151 at 5127 (PURPA conference report).

<sup>20</sup>18 C.F.R. § 2.79(a) (1983).

<sup>21</sup>18 C.F.R. § 2.79(c), (d) (1983).

<sup>22</sup>18 C.F.R. § 2.79(e), (f) (1983).

<sup>23</sup>18 C.F.R. § 2.79(i) (1983).

<sup>24</sup>See *supra* note 17.

<sup>25</sup>Order No. 2, [Reg. Preambles 1979-1981] FERC Stat. & Reg. ¶ 30,005 at 30,023 and 30,036 (Appendix A).

<sup>26</sup>*Id.* at 30,036 (Appendix B).

<sup>27</sup>18 C.F.R. § 2.56(a) (1983).

<sup>28</sup>Order No. 2, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,005 at 30,036 (Appendix B).

<sup>29</sup>*Id.* at 30,023.

Order No. 2 extended the direct sale program in one significant way: it allowed intrastate pipelines to participate in the transportation arrangements,<sup>30</sup> in order to minimize the distance the gas had to travel, and therefore its cost to the end-user. Such participation would involve intrastate pipelines in interstate transportation of gas. To encourage their participation, the Commission stated that it would assert its transportation jurisdiction only as to the Order No. 533 service performed, and would pre-grant permission to abandon the interstate service at the end of the certificate's term.<sup>31</sup>

The Commission also noted that brokers had participated in several transactions for which certificates had been sought, by bringing producers and end-users seeking gas together. It stated that it did not seek to discourage these "important activities" but nonetheless was concerned about the impact of brokers' fees on the delivered price paid by the end-user, and therefore would review that impact to determine whether the transaction was in the public interest.<sup>32</sup>

By October 1979, the enactment of the NGPA had ended the legally bifurcated market for new natural gas, and the gas shortage had eased; now, however, there was the threat of a fuel oil shortage. The Federal Energy Regulatory Commission ("FERC"), the successor to the Federal Power Commission, responded by modifying the Order No. 533 program, changing its emphasis from gas supply to fuel-oil displacement. When gas was short, its use to fire boilers had been discouraged, and the program included restrictions to ensure that it was not used to transport gas for this purpose. With oil now the center of attention, however, displacing fuel oil with gas as a boiler fuel became a policy goal. Order No. 52<sup>33</sup> stated that in any new certificates issued under the program, end-use restrictions on direct-sale gas would be removed, permitting high-priority customers, such as those using gas for process or feedstock, also to displace fuel oil.<sup>34</sup> Existing certificates could be amended by a one-time "blanket" filing.<sup>35</sup>

*b. The Order No. 27 program*

The Order No. 533/Order No. 2 program was limited to high-priority industrial and commercial end-users. Order No. 27,<sup>36</sup> issued in 1979, established a mechanism for facilitating direct producer sales to certain non-industrial end-users: those using gas for essential agricultural uses<sup>37</sup> or in a school, hospital or similar institution.<sup>38</sup> These uses the Commission defined as "high-priority uses"<sup>39</sup> so as to bring its certification of transportation for such uses within the ambit of the then newly-amended Section 7 of the Natural Gas Act, which expressly authorized the

<sup>30</sup> 18 C.F.R. § 2.79(g)(1) (1983).

<sup>31</sup> Order No. 2, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,005 at 30,030.

<sup>32</sup> *Id.* at 30,029.

<sup>33</sup> In the Matter of Fuel Oil Displacement by Process and Feedstock Users, Docket No. RM80-1, Order No. 52, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,088 (1979), 44 Fed. Reg. 60080 (1979) (codified at 18 C.F.R. § 2.79 (k)-(n)).

<sup>34</sup> 18 C.F.R. § 2.79(l), (m) (1983). End-users who were not high-priority users could have gas transported for boiler fuel under Order No. 30, discussed *infra* text at note 68.

<sup>35</sup> 18 C.F.R. § 2.79(k) (1983).

<sup>36</sup> Certification of Pipeline Transportation for Certain High Priority Uses, Docket No. RM79-18, Order No. 27, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,049 (1979), 44 Fed. Reg. 28425 (1979) (codified at 18 C.F.R. Part 157, Subpart E (§§ 157.100-157.105)).

<sup>37</sup> 18 C.F.R. § 157.102(a)(1) (1983) (defining "essential agricultural use" as any use certified as such by the Secretary of Agriculture under Section 401(c) of the Natural Gas Policy Act of 1978 ("NGPA"), 15 U.S.C. § 3391(c) (1982)).

<sup>38</sup> 18 C.F.R. § 157.102(a)(2) (1983).

<sup>39</sup> 18 C.F.R. § 157.102(c) (1983).

Commission to certificate transportation of gas bought directly from producers by end-users for high-priority end-uses.<sup>40</sup>

Although it generally parallels the Order No. 533 program, the Order No. 27 program is much less restricted. It is not limited to existing customers of the transporting pipeline<sup>41</sup> and the user need not be able to use an alternative fuel.<sup>42</sup> There is also no requirement that the user's supplying pipeline be faced with curtailment,<sup>43</sup> and there are no limitations imposed on the quantity of gas that can be transported to the end-user.<sup>44</sup>

There also was some slight procedural liberalization: either the pipeline or the end-user could apply for the certificate,<sup>45</sup> and the certificate could be granted for five years, or for ten if the user owned the reserves,<sup>46</sup> rather than for two as under the Order No. 533 program.<sup>47</sup> But the procedure continued to be one of granting individual certificates for individual transactions.

And the Order No. 27 program, like the Order No. 533 program, is limited to gas not required by law to flow in interstate commerce. In the case of the Order No. 533 program, whose "stated purpose . . . was to supplement available pipeline supply by making what otherwise would be intrastate gas accessible to curtailed interstate customers through direct purchase,"<sup>48</sup> the Commission did not even feel it necessary to say that transportation of gas dedicated<sup>49</sup> to the interstate market was not eligible for certification under the program.<sup>50</sup> In Order No. 27, the Commission explicitly excluded gas that was committed or dedicated to interstate commerce at enactment of the NGPA,<sup>51</sup> explaining that it was "not prepared to jeopardize the availability of low-cost supplies to existing customers to make such gas available through direct sales to new customers or to existing customers seeking increased loads."<sup>52</sup> By allowing a waiver of the exclusion if it could be shown to be in the public

<sup>40</sup>See *supra* note 19.

<sup>41</sup>Compare 18 C.F.R. § 2.79(e) (1983).

<sup>42</sup>Compare 18 C.F.R. § 2.79(c) (1983). Under Order No. 27, users of natural gas can be eligible users even if they could economically use alternative fuels. This is the case even though such users would not be eligible for protection against curtailment under NGPA § 401(b), 15 U.S.C. § 3391(b) (1982). The Commission explained that:

Although NGPA section 401(b) imposes this alternative fuel test upon essential agricultural users which seek priority access to low-cost pipeline supplies, the policy underlying that test does not apply to direct sales. . . . Unlike curtailment priorities, direct sale gas is not allocated at the expense of other consumers.

Order No. 27, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,049 at 30,347.

<sup>43</sup>Compare 18 C.F.R. § 2.79(e) (1983).

<sup>44</sup>Compare 18 C.F.R. § 2.79(e), (f) (1983) (volumetric limitations imposed in certificates issued before October 5, 1979) with 18 C.F.R. § 2.79(m)(2) (1983) (current volumetric restrictions).

<sup>45</sup>18 C.F.R. § 157.101(a) (1983).

<sup>46</sup>18 C.F.R. § 157.105(a), (b) (1983).

<sup>47</sup>18 C.F.R. § 2.79(i) (1983).

<sup>48</sup>Order No. 2, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,305 at 30,023.

<sup>49</sup>See *infra* text at note 139.

<sup>50</sup>Since by law such gas had to be sold to the pipeline to which it had been dedicated, its availability for direct sale would also have required the Commission's permission, under Section 7(b) of the Natural Gas Act, 15 U.S.C. § 717f(b) (1982), to abandon that sale. In a time of shortage of gas for the interstate market, it was highly unlikely that the Commission would have permitted abandonment, especially since the effect of permitting it might have been the direct sale of the gas, perhaps to the same customers who would have received it anyway, at a price higher than their supplying pipeline could legally have paid for it.

The Commission actually limited eligible gas further under Order No. 533. Transportation certificates will not be granted for gas already committed to jurisdictional pipelines under an advance payment plan, or for gas sold by an affiliate or a producing division of such pipelines. 18 C.F.R. § 2.79(d) (1983).

<sup>51</sup>See *infra* note 145.

<sup>52</sup>Order No. 27, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,049 at 30,349. The exclusion is contained in 18 C.F.R. § 157.104(a) (1983).



interest,<sup>53</sup> the Commission did, however, declare its intention to give "careful consideration," on a case-by-case basis, to the use of committed or dedicated reserves.<sup>54</sup>

*c. Section 311*

Both the continued requirement of prior administrative approval for each transaction and the exclusion of dedicated and committed gas had in fact already been eliminated in the special transportation program adopted by Congress in section 311 of the NGPA.<sup>55</sup> Section 601(a)(2) of the NGPA<sup>56</sup> expressly provides that the Commission's Natural Gas Act jurisdiction does not apply to transportation authorized under section 311. The Commission, for the first time therefore, could permit interstate transportation without issuing a section 7 certificate. Even before issuing Order No. 27, the Commission had issued section 311 regulations<sup>57</sup> authorizing interstate and intrastate pipelines to transport gas without prior Commission approval.

Under section 311, the transportation has to be "on behalf of" a local distribution company.<sup>58</sup> For both interstate and intrastate pipelines, the regulations authorize transportation without prior approval only if the local distribution company "receives such natural gas for its system supply for resale."<sup>59</sup> At first blush, the regulations would seem to prevent section 311 transportation without prior approval for a direct sale to an end-user or independent marketer; only a direct producer sale to a distributor seemingly would qualify. The Commission has, however, construed the system supply requirement broadly. In its 1982 *Natural Gas Pipeline Company* decision,<sup>60</sup> the Commission issued Natural, a major jurisdictional pipeline, a certificate for an off-system sale to Bridgeline Gas Distribution Company, a Hinshaw pipeline.<sup>61</sup> The gas was to be transported under section 311 by Natural to another interstate pipeline, which would deliver it under section 311 to an intrastate pipeline for delivery — again under section 311 — to Bridgeline. Bridgeline proposed to resell the gas to a large electric utility for use in two generating plants; it was also negotiating to resell some of the gas to another, smaller, utility.<sup>62</sup> The two utilities were Bridgeline's only customers<sup>63</sup> and the gas to be transported under section 311 possibly was for the use of only one of them. The Commission found the system-supply requirement to be satisfied because Bridgeline's sale to its customers was regulated as to rates and curtailments by the state conservation commission.<sup>64</sup>

<sup>53</sup> 18 C.F.R. § 157.104(b) (1983).

<sup>54</sup> Order No. 27, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,049 at 30,349.

<sup>55</sup> 15 U.S.C. § 3371 (1982).

<sup>56</sup> *Id.* § 3431(a)(2).

<sup>57</sup> 18 C.F.R. Part 284, Subparts A-F (1983). See generally Mogel & White, 58 N.D. L.Rev. 575 (1982) (discussion of legislative history and Commission's implementation of section 311).

<sup>58</sup> See 18 C.F.R. § 284.102(a)(1)(ii) (1983) (transportation by interstate pipelines); *id.* § 284.122(a)(1)(ii) (1983) (transportation by intrastate pipelines).

<sup>59</sup> 18 C.F.R. § 284.102(b)(1)(ii) (1983) (interstate pipelines); 18 C.F.R. § 284.122(b)(1)(ii) (1983) (intrastate pipelines). Where the "system supply" test is not satisfied, the pipeline can transport gas under section 311 only with the Commission's prior authorization. 18 C.F.R. § 284.102(b)(2) (1983) (interstate pipelines); 18 C.F.R. § 284.122(b)(2) (1983) (intrastate pipelines).

<sup>60</sup> *Natural Gas Pipeline Company of America*, 20 FERC ¶ 61,128 (1982).

<sup>61</sup> *Bridgeline Gas Distribution Company*, 20 FERC ¶ 61,127 (1982) (declaring Bridgeline to qualify as a Hinshaw pipeline; *i.e.*, qualifying under Section 1(c) of the NGA, 15 U.S.C. § 717(c) (1982), for exemption from the Commission's jurisdiction).

<sup>62</sup> *Natural*, 20 FERC ¶ 61,128 at 61,282.

<sup>63</sup> Bridgeline's distribution system consists of three lines, each serving an electric generating plant. *Bridgeline*, 20 FERC ¶ 61,127.

<sup>64</sup> *Natural*, 20 FERC ¶ 61,128 at 61,284 n. 5.

In its 1983 *Texaco* decision<sup>65</sup> (granting Texaco a certificate for a direct sale of Outer Continental Shelf ("OCS") gas to Bridgeline), the FERC noted, however, that its finding in *Natural* was "predicated upon Bridgeline having more than one customer."<sup>66</sup> Taking these two decisions together, it seems that a purchase by a local distribution company with only two customers will permit section 311 transportation to be used to facilitate what is very close to a direct sale. In *Texaco*, Bridgeline may have had more than one customer, but the Commission approved the transaction even though, again, the gas might have been going to only one of its customers. The interstate pipeline which was to transport the gas under section 311 authorization was a Texaco affiliate; the intrastate pipeline and Bridgeline, the purchasing local distribution company, were wholly-owned by Texaco.<sup>67</sup> The net effect of the transaction thus was a direct sale by Texaco to an electric utility, with the gas transported by Texaco companies without any need for prior Commission authorization. Indeed, had Texaco not needed a certificate for the sale itself — because it involved OCS gas — the whole transaction could have taken place without prior Commission authorization.

Certain requirements must be met, however. There must be at least one other customer (even if that customer does not receive the gas), and the sale must be subject to state price and allocation regulation. Those requirements probably are met easily enough. The principal obstacles to the use of section 311 to transport gas for a direct sale to an end-user probably are found in state regulation. Some commissions may be unwilling to allow the benefit of gas purchased by a distribution company to be directed to a single customer rather than rolled into system supply.

*d. The Order No. 30 Program*

The original aim of Order No. 533, Order No. 27, and section 311 was to supplement the supply of gas to the interstate market. By contrast, the aim of Order No. 30, issued in May 1979,<sup>68</sup> was to make natural gas available to end-users through direct sales in order to displace fuel oil. At the time, there already was a "critically short supply" of middle distillate fuel oil, and it appeared that stocks would be insufficient for the winter of 1979-1980.<sup>69</sup> Having only recently been faced with a gas shortage, the Commission was reluctant to take any steps that would increase gas use. But it stated that the Commission's "responsibility to high priority customers, regardless of the type of fuel consumed, compel[ed] our action" despite the risks.<sup>70</sup>

The program essentially took the form of an authorization of transportation, in certain circumstances, under section 311 of the NGPA.<sup>71</sup> It authorized interstate

<sup>65</sup>*Texaco, Inc.*, 25 FERC ¶ 61,172 (1983), *reh. granted for purposes of further consideration* (Oct. 3, 1983). The Commission there issued a certificate for a direct sale by Texaco to Bridgeline, with the gas to be transported by an interstate and an intrastate pipeline under section 311 authorization. The gas was proposed to be sold by Bridgeline to its two customers. *Id.* at 61,474.

<sup>66</sup>*Id.* at 61,476 n. 5.

<sup>67</sup>*Id.* at 61,474, 61,476 nn. 2 & 4.

<sup>68</sup>Transportation Certificates for Natural Gas for the Displacement of Fuel Oil, Docket No. RM79-34, Order No. 30, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,054, 44 Fed. Reg. 30,323 (1979), *amended on rehearing*, Order No. 30-A, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,084 (1979), 44 Fed. Reg. 54,472 (1979) (codified at 18 C.F.R. Part 284, Subpart F (§§ 284.200-.208)).

<sup>69</sup>Order No. 30, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,054 at 30,371-72.

<sup>70</sup>*Id.* at 30,372.

<sup>71</sup>*See supra* text at note 55. As originally enacted, the regulations also exempted certain types of transportation altogether from certification, using the emergency powers of Section 7(c)(1)(B) of the NGA, 15 U.S.C. § 717f(c)(1)(B) (1982). *See* Order No. 30, 44 Fed. Reg. 30,323 (codified at 18 C.F.R. § 284.202(a)(1)). This emergency exemption was withdrawn in 1980. Order No. 30-B, 45 Fed. Reg. 56,046 (1980), amending 18 C.F.R. § 284.202(a).

pipelines to transport gas for ultimate delivery to eligible purchasers.<sup>72</sup> Intrastate pipelines were also authorized, under section 311, to transport gas purchased by an eligible user, if the gas was also transported by an interstate pipeline under the program.<sup>73</sup> To be eligible, purchasers had to use gas for purposes certified by the Economic Regulatory Administration,<sup>74</sup> which required that the gas only be used to displace fuel oil, and not coal, that would otherwise have been consumed by the end-user.<sup>75</sup> The transportation was authorized only during the "fuel shortage emergency period," initially defined as ending on June 1, 1980,<sup>76</sup> but extended in several stages until November 5, 1983, when the program ended.<sup>77</sup> By 1980, when the program was extended into 1981, there was no longer a fuel shortage in absolute terms as there was in 1979. The Commission based the extension on the general need to reduce oil imports. An oversupply of natural gas in the interstate market also supported continuation of the program.<sup>78</sup>

Perhaps the most significant aspect of the Order No. 30 program was its authorization of transportation under section 311 without imposing any requirement that the gas be for the "system supply" of a pipeline or local distribution company. As discussed above, the Commission's earlier regulations permitting transportation under section 311 without prior approval do so require,<sup>79</sup> thus making it more difficult to arrange transportation of gas for direct sales to end-users under those regulations.

Section 311 states that the Commission may authorize both inter- and intrastate pipelines to transport gas "on behalf of" intrastate pipelines or local distribution companies.<sup>80</sup> Addressing the difference between the interpretation given this phrase in its general section 311 regulations and in Order No. 30, the Commission explained that when it issued its section 311 regulations, it "did not exercise the full breadth of its legal authority under NGPA section 311(a) and did not rely upon . . . [a] broad interpretation of 'on behalf of' . . ."<sup>81</sup> But in developing Order No. 30:

<sup>72</sup> 18 C.F.R. §§ 284.202, 284.201(b) (1983).

<sup>73</sup> 18 C.F.R. § 284.203 (1983).

<sup>74</sup> 18 C.F.R. § 284.202(c), (d) (1983).

<sup>75</sup> 10 C.F.R. § 595.3 (1983).

<sup>76</sup> Order No. 30, 44 Fed. Reg. at 30,329.

<sup>77</sup> Order No. 30-B, 45 Fed. Reg. 34,364 (1980), extended the period on an interim basis to August 31, 1980. Order No. 30-D, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,184, 45 Fed. Reg. 56,046 (1980), extended the program until May 1, 1981. The Commission extended the program in 1981 until 90 days after the effective date of the final rule to be issued in Phase I of its blanket certificate program. Order No. 30-F, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,263 (1981), 46 Fed. Reg. 30,491 (1981). In 1982, the final rule of the Phase I program extended the Order No. 30 program yet again, until 90 days after the effective date of the final rule in Phase II of the Commission's blanket certificate rulemaking. Order No. 234, *infra* note 83, 47 Fed. Reg. at 24,274. The final rule of the Phase II program concluded that there no longer was a basis for finding that a fuel oil shortage emergency existed, and thus did not extend the Order No. 30 program. Order No. 319, *infra* note 86, 3 FERC Stat. & Reg. ¶ 30,477 at 30,608. The Order No. 30 program thus expired on November 3, 1983, 90 days after the effective date of Order No. 319. Effective Date and Erratum Notice, 3 FERC Stat. & Reg. ¶ 30,479 (1983), 48 Fed. Reg. 35,635 (1983) (establishing effective date of Order No. 319 as August 5, 1983).

<sup>78</sup> Order No. 30-D, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,184 at 31,280-83.

<sup>79</sup> See *supra* text at n.59. The only other existing exception to the "system supply" requirement for transportation under section 311 without prior authorization is in the case of incidental transportation by intrastate pipelines for end-users, where the gas also is transported by an interstate pipeline under a blanket certificate. See *infra* note 91.

<sup>80</sup> 15 U.S.C. § 3371(a)(1)(A), (a)(2)(A) (1982).

<sup>81</sup> Order No. 30, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,054 at 30,374.

"[T]he Commission recognized that the need to develop a truly national transportation system pertains not only to the transportation of system supplies but also to the interstate transportation of gas owned by a particular end-user. The Commission believes it should exercise its discretion under Section 311 to permit the efficient and timely transportation of natural gas to serve a use found to be in the national interest and necessary to help manage the nation's fuel supply problems."<sup>82</sup>

*e. 1975-1979: A summary*

Regulations and legislation during 1975-1979 created four general openings for the transportation of direct producer sale gas. Probably the least important were the two programs intended to move gas directly to high-priority end-users. Those programs partly abandoned the Commission's previous general substantive opposition to direct producer sales in the interstate market, but left essentially untouched the requirement of prior administrative approval of each transaction. The other two openings avoided that requirement. The Commission's general section 311 regulations served best for sales to distribution companies. With cooperative state regulators, those regulations could be used to authorize what was in essence a direct sale to an end-user, but direct sales to boiler fuel users were generally more readily made under the Order No. 30 regulations.

The pace of regulatory change then slackened for a time after 1979. When it resumed in 1982, the focus of attention had shifted to the natural gas surplus, and to the general goal of creating more open and competitive gas markets.

*2. 1982-1984*

*a. Blanket certificates*

In 1982, the Commission started to reform and simplify its certificate regulations by authorizing "blanket certificates" for interstate pipelines.<sup>83</sup> A blanket certificate is a certificate authorizing a pipeline to undertake whole classes of activities, subject only to reporting requirements and, in some cases, to giving prior notice of its activities and an opportunity for interested parties to file protests.<sup>84</sup> Thus, a blanket certificate holder need not seek prior approval, through issuance of a separate certificate, for each generically authorized jurisdictional activity that it undertakes.

In the first phase of the blanket certificate program, the activities authorized under the certificates were routine ones such as sales taps and storage services.<sup>85</sup> But in a second phase in 1983 the Commission authorized transportation under blanket certificates for all end-users.

In Order No. 319,<sup>86</sup> the Commission authorized transportation under blanket

<sup>82</sup>*Id.*

<sup>83</sup>Interstate Pipeline Blanket Certificates for Routine Transactions, Docket No. RM81-19-000, Order No. 234, 3 FERC Stat. & Reg. ¶ 30,368 (1982), 47 Fed. Reg. 24,254 (1982), *reh. granted in part and denied in part*, Order No. 234-A, 3 FERC Stat. & Reg. ¶ 30,389 (1982), 47 Fed. Reg. 38,871 (1982) (codified at 18 C.F.R. Part 157, Subpart F (§§ 157.201-157.218)).

<sup>84</sup>*Id.*, 3 FERC Stat. & Reg. ¶ 30,368 at 30,198.

<sup>85</sup>*Id.* (promulgating 18 C.F.R. §§ 157.211, 157.213).

<sup>86</sup>Sales and Transportation by Interstate Pipelines and Distributors, Docket No. RM81-29-000, Order No. 319, 3 FERC Stat. & Reg. ¶ 30,477 (1983), 48 Fed. Reg. 34,872 (1983), *effective date established*, 3 FERC Stat. & Reg. ¶ 30,479 (1983), 48 Fed. Reg. 35,635 (1983) (establishing effective date of August 5, 1983), *reh. granted in part and denied in part*, Order No. 319-A, 25 FERC ¶ 61,194 (1983), 48 Fed. Reg. 51,436 (1983) (codified at 18 C.F.R. §§ 157.209 and 157.202(a)(13),(14)). Rehearing of Order Nos. 234-B and 319 is pending with respect to the authorization by blanket certificate of certain off-system sales.

certificates for high priority end-users for high priority end-uses. These end-uses and users were defined<sup>87</sup> to include those eligible under either the Order No. 2<sup>88</sup> or the Order No. 27<sup>89</sup> programs. Other requirements also were consistent with the less restrictive requirements of the Order No. 27 program.<sup>90</sup> Order No. 319 thus authorized transportation to hospitals, schools or similar institutions, to large commercial establishments and to end-users for plant protection, process or feedstock use or for essential agricultural uses.<sup>91</sup> For these purposes, transportation under a blanket certificate is automatically authorized for up to five years (or up to ten years if the end-user owns and develops the reserves from which the gas is produced).<sup>92</sup> Transportation for longer periods is also authorized, subject only to the pipeline's requesting authorization of the transportation, and to either the absence of protest against the request, or to resolution and withdrawal of the protest within 30 days.<sup>93</sup>

A companion order to Order No. 319, Order No. 234-B,<sup>94</sup> designated *all* end-uses as eligible to receive gas transported under blanket certificates.<sup>95</sup> Transportation for up to 120 days is automatically authorized;<sup>96</sup> for longer periods, the notice-and-protest procedure applies.<sup>97</sup> Unlike Order No. 319, however, Order No. 234-B was not adopted as a permanent regulation. The extension of blanket

<sup>87</sup> 18 C.F.R. § 157.202(a)(13), (14).

<sup>88</sup> 18 C.F.R. § 2.79(a) (1983).

<sup>89</sup> 18 C.F.R. § 157.102 (1983).

<sup>90</sup> Thus, under a blanket certificate, there is no requirement that the user not have the capability to use alternative fuels. (Compare the Order No. 2 requirement at 18 C.F.R. § 2.79(c) (1983).) Nor is any limit imposed on the volume of gas that may be transported to an end-user under the blanket certificate. (Compare 18 C.F.R. § 2.79(e),(f),(1),(n) (1983).) Nor is transportation availability restricted to existing customers. (Compare 18 C.F.R. § 2.79(e).)

<sup>91</sup> 18 C.F.R. § 157.202(a)(13), (14). Order No. 319 also amended the Commission's section 311 regulations so as to allow an intrastate pipeline to transport gas intended for an end-user, if the gas is also transported by an interstate pipeline under a blanket certificate. 18 C.F.R. § 284.122(b)(1)(B)(ii), as amended by Order No. 319. That amendment has the effect also of allowing either a local distribution company, or a Hinshaw pipeline which holds a blanket certificate under 18 C.F.R. § 284.221 (1983) (authorizing it to engage in transportation to the same extent as an intrastate pipeline may under section 311), to transport gas for an end-user if the gas also is transported by an interstate pipeline under a blanket certificate. 18 C.F.R. § 284.222(b) (incorporating by reference 18 C.F.R. § 284.122). Thus, gas purchased in a direct sale could be transported from the wellhead by an intrastate pipeline under section 311 to an interstate pipeline; shipped by the interstate pipeline, under a blanket certificate, to a local distribution company; and, finally, transported to the purchasing end-user by the local distribution company under its blanket certificate. No prior Commission authorization specific to any of the transactions would be necessary.

<sup>92</sup> 18 C.F.R. § 157.209(a).

<sup>93</sup> 18 C.F.R. § 157.209(b)(1). The notice-and-protest procedure is set out in 18 C.F.R. § 157.205. The pipeline must complete the procedure before starting an activity to which the procedure applies. If no protests against the request are filed within 45 days of issuance by the Commission of a notice of the request, the transportation is authorized. If a protest is filed, and not resolved and withdrawn within 30 days from the deadline for filing protests, the transportation is not authorized by the blanket certificate, and the request for authorization is treated as an application under section 7 of the NGA for a regular certificate for the transportation. *Id.*

<sup>94</sup> Interstate Pipeline Blanket Certificates for Routine Transactions and Sales and Transportation by Interstate Pipelines and Distributors, Docket Nos. RM81-190-000, RM81-29-000, Order No. 234-B, 3 FERC Stat. & Reg. ¶ 30,476 (1983), 48 Fed. Reg. 34,872 (1983) (codified at 18 C.F.R. § 157.209(e)), *effective date established*, 3 FERC Stat. & Reg. ¶ 30,479 (1983), 48 Fed. Reg. 35,635 (1983) (establishing effective date of August 5, 1983).

<sup>95</sup> 18 C.F.R. § 157.209(e)(1) and (e)(2).

<sup>96</sup> 18 C.F.R. § 157.209(a)(2) and (e)(1).

<sup>97</sup> 18 C.F.R. § 157.209(b)(2) and (e)(2). Since transportation for any end-use is automatically authorized for up to 120 days, it can commence while the notice-and-protest procedure is being followed. But the transportation will have to be suspended if the procedure is not completed within the 120-day automatic authorization period.

certificate transportation to all end-uses and end-users was viewed by the Commission as an experiment, and Order No. 234-B by its own terms will expire on June 30, 1985 unless extended by the Commission.<sup>98</sup>

Order No. 319 also introduced an incentive for pipelines to transport gas for end-users. The Commission pointed out there that a pipeline may be "less than enthusiastic about tailoring its overall operations to accommodate the requirements of such relatively unfamiliar, small volume shippers."<sup>99</sup> To help overcome this reluctance, Order No. 319 authorized those pipelines which pass on to their on-system customers revenues earned from providing transportation services to charge end-users up to an additional five cents for transportation of each volume of gas containing a million British thermal units ("MMBtu").<sup>100</sup> The additional charge, to be retained by the pipeline, is available until January 31, 1985 on an experimental basis to act as an incentive to pipelines to provide transportation for end-users. The additional five-cent charge is not available to a pipeline that projects transportation volumes in its rate case rather than crediting transportation revenues to its customers. And even for pipelines that do credit transportation revenues, the additional charge is not compulsory; end-user purchasers must agree to pay it. Given the softness of some markets for natural gas because of competition from other fuels, the Commission expected that the charge would actually be absorbed by the seller in the form of a lower price.<sup>101</sup>

The blanket certificate regulations permit the gas that is to be transported under a certificate to be purchased from any seller, including an independent marketer or a reseller,<sup>102</sup> with two exceptions. First, an interstate pipeline is not an eligible seller, except to the extent that it sells production by its affiliate. Second, a local distribution company also is not an eligible seller, except to the extent that it sells gas from its local sources of supply or from its own production or that of its affiliate. As a result, blanket certificates do not generally authorize off-system sales by interstate pipelines, except when the pipeline sells its affiliate's production. Nor could such a sale be carried out under Order No. 319 by having a local distribution

<sup>98</sup> 18 C.F.R. § 157.209(a).

<sup>99</sup> Order No. 319, 3 FERC Stat. & Reg. ¶ 30,477 at 30,613.

<sup>100</sup> 18 C.F.R. § 157.209(f).

<sup>101</sup> Order No. 319, 3 FERC Stat. & Reg. ¶ 30,477 at 30,615.

<sup>102</sup> See Order No. 319-A, *supra* n. 86, 3 FERC Stat. & Reg. ¶ 30,512 at 30,771 (amending § 157.209 to extend eligibility criteria for sellers so as to include independent marketers and resellers).

company sell to the end-user gas received from the system supply of an interstate pipeline.<sup>103</sup>

There is another significant limitation on the gas that can be transported to an end-user under a blanket certificate: it must not have been committed or dedicated<sup>104</sup> to interstate commerce on the day before enactment of the NGPA.<sup>105</sup> This requirement's impact on transportation for direct sales is considered below.<sup>106</sup>

The Commission's direct sale program under blanket certificates was prompted by market conditions in the natural gas industry. The Commission reported that rising natural gas prices and falling fuel oil prices meant that the delivered price of gas was approaching or even exceeding the price of alternative fuels. Interstate pipelines claimed to have lost industrial load because of conservation, the recession and competition from other fuels. Yet because of rolled-in pricing<sup>107</sup> and high take-or-pay obligations,<sup>108</sup> the pipelines seemed unable to respond to price competition and the consequent loss of load. As a result, some industrial end-users

<sup>103</sup>18 C.F.R. § 157.209(a)(i)(A), (e)(1)(i)(A) and (e)(2)(i)(A). The regulations achieve this result by, initially, making eligible any seller who sells in a "first sale," except an interstate pipeline which sells gas produced by itself. "First sale" is defined by section 2(21) of the NGPA, 15 U.S.C. § 3301(21) (1982), to include all sales except sales by interstate pipelines, intrastate pipelines or local distribution companies. But sales by those three types of entities of their own production or that of their affiliates are defined by the statute as first sales. Thus the blanket certificate regulations initially *exclude* from eligibility the following:

- Sales by interstate pipelines, but not sales of gas produced by their affiliates (Sales of their own production are specifically excluded from eligibility.);
- Sales by intrastate pipelines, but not sales of their own production or that of their affiliates; and
- Sales by local distribution companies but, again, not sales of their own production or that of their affiliates.

But the blanket certificate regulations then add back some of these excluded sellers to the class of eligible sellers. They specifically provide that intrastate pipelines and local distribution companies (to the extent that the gas is attributable to the latter's local supplies) *are* eligible sellers. The end result, therefore, is that all sellers are eligible *except* the following:

- Interstate pipelines, but they are eligible to the extent they sell gas produced by their affiliates; and
- Local distribution companies, but they are eligible to the extent they sell (i) gas attributable to their local supplies; (ii) gas produced by themselves; or (iii) gas produced by their affiliates.

The effect of the blanket certificate seller eligibility regulations is thus that interstate pipelines may not, in general, use them to make off-system sales, nor can local distribution companies, in general, make such sales. Some off-system sales are, however, specifically authorized by a blanket certificate. See 18 C.F.R. § 157.210.

<sup>104</sup>See *infra* text at note 143.

<sup>105</sup>18 C.F.R. § 157.209(a)(1)(i)(B), (C) and (a)(1)(ii); 157.209(e)(1)(i)(B), (C) and (e)(1)(ii); 157.209(e)(2)(i)(B), (C) and (e)(2)(ii). This restriction does not apply to gas sold by an intrastate pipeline, by a local distribution company from its local supplies, or to gas produced from reserves owned and developed by the end-user. Thus, gas sold by an intrastate pipeline to an end-user could be transported by an interstate pipeline under a blanket certificate.

<sup>106</sup>*Infra* text at note 148.

<sup>107</sup>To the extent that a pipeline uses rolled-in pricing, the price paid by each of its customers is based on the pipeline's total costs, and not on the cost of particular facilities or contracts that are considered to be for the particular benefit of that customer. Applied to purchased gas costs, rolled-in pricing implies that only a pipeline's average purchased gas cost is relevant to the price paid by its customers. When pipelines were aggressively purchasing gas after enactment of the NGPA, this meant that high prices paid under individual contracts did not make the gas unmarketable if the pipeline also had an adequate inventory of inexpensive gas. For the same reason, in a surplus market like the present one, price concessions by a producer under one contract have little effect on the price of gas to the pipeline's customers. One reason for the use of direct producer sales in the pipelines' special marketing programs, see *infra* text at note 117, is to avoid having the price concessions by the producers who participate in the programs rolled in with the average cost of the pipelines' system supply.

might consider switching to other fuels, even though some producers might be willing to sell gas to them at competitive prices.<sup>109</sup>

The Commission was concerned that this disparity — between pipelines' rolled-in delivered gas prices and the price at which producers were willing to sell new supplies — might produce detrimental results for gas consumers. To the extent that this distortion caused industrial end-users to switch to alternative fuels, the remaining users would have to pay a larger share of their supplying pipelines' fixed costs. In addition, a lower demand for gas might lead to less exploration and development of new gas supplies.<sup>110</sup>

Given this scenario, the Commission found transportation for direct sales would serve the public convenience and necessity — the standard for granting a transportation certificate<sup>111</sup> — for three reasons. First, direct sale arrangements make price competition from fuels competing with gas felt directly at the wellhead and thus serve to keep wellhead prices responsive to reductions in the price of other fuels.<sup>112</sup> Second, by providing end-users with an alternative to purchasing all their gas requirements from the system supply of a distributor or interstate pipeline, a direct sale program encourages pipelines to adopt gas purchasing practices which keep their delivered prices competitive.<sup>113</sup> Third, to the extent that an end-user buys gas in a direct sale instead of switching to another fuel, its payment to the pipeline for transportation of the gas continues to bear some of the fixed costs that otherwise might have to be shifted to its other customers.<sup>114</sup>

With its approval of blanket certificates which authorize transportation to all end-users, the Commission's view of such transportation has undergone another transformation. Originally, it was opposed to such transportation because end-users might bid up the price of gas and attract it away from pipeline supply.<sup>115</sup> Then, faced with a gas shortage and regulated interstate prices that were too low to attract gas, the Commission made transportation available for some end-users in the hope that price competition would alleviate a shortage by bringing additional gas to customers of interstate pipelines, even if they had to pay unregulated market prices for it.<sup>116</sup> Now, the Commission again hopes that direct purchases will send price signals to the wellhead. But this time, faced with a gas surplus and prices that are too high, the desired result is to drive down the price so that demand will increase.

Thus, the Commission's first policy on transportation for end-users was to prevent it, in an attempt to insulate the interstate market from price signals. That having failed, the Commission tried to use transportation to raise the price and increase supply. Now, the Commission seeks to use it to lower the price and increase demand.

<sup>108</sup> A take-or-pay obligation requires a pipeline to pay for a certain volume of gas — typically defined as a percentage of the total deliverability of the wells covered by the pipeline's contract with a producer — even if it does not take the gas. Typically, the pipeline is allowed a period of time in which it can take gas which it was not able to take earlier and for which it has already paid. But if it cannot "make up" within the period, the amounts it has paid for the gas it could not take are lost to it. Even if the pipeline can later make up, its earlier payments under the take-or-pay obligation are in effect interest-free loans to the producer. Take-or-pay obligations limit the ability of a pipeline to lower its average gas cost by taking steps such as reducing its purchases under its high-cost contracts and increasing purchases under existing or new lower-cost contracts.

<sup>109</sup> Order No. 234-B, 3 FERC Stat. & Reg. ¶ 30,476 at 30,599.

<sup>110</sup> *Id.*

<sup>111</sup> NGA § 7(c)(1)(A), 15 U.S.C. § 717f(c)(1)(A) (1982).

<sup>112</sup> Order No. 234-B, 3 FERC Stat. & Reg. ¶ 30,476 at 30,599.

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Supra* text at note 12.

<sup>116</sup> *Supra* text at note 14.



*b. Special Marketing Programs*

Another avenue for direct producer sales has been created by the Commission's recent approval of several natural gas special marketing plans ("SMPs"). As of March 23, 1984, four plans proposed by pipelines<sup>117</sup> and one by a producer<sup>118</sup> had been approved. Like blanket certificates, the plans constitute another attempt to reduce gas prices by encouraging competition among gas producers.

The programs' common denominator is that they all are based on direct producer sales of gas that had been contractually committed to a pipeline or a local distribution company. The gas is temporarily released by the pipeline or distributor; the producer then sells it directly<sup>119</sup> to an end-user or distributor at a price lower than the one established by the producer's original contract with the pipeline or distributor. The gas is transported by the pipeline at a rate that generally is equal to the transportation component of the price at which the releasing pipeline would have sold the gas if the pipeline had purchased it for system supply. The marketing advantage of the special marketing programs thus rests on producer price concessions rather than on a reallocation of fixed transmission costs.

The SMPs differ with respect to the degree of involvement of the pipeline. Both industrial sales programs ("ISPs") and contract carriage programs ("CCPs") involve direct producer sales to end-users and distributors. Under an ISP, the pipeline first identifies volumes of sales to particular customers that probably would be lost, but for the ISP, because of competition from cheaper fuels. The pipeline then contacts its producer-suppliers and declines to buy the volumes which it will not be able to resell. This creates a pool of surplus gas available for sale. In return for a release by the producers from its contractual duty to pay for the surplus gas whether it takes it or not, the pipeline offers to arrange for the surplus gas to be purchased directly

<sup>117</sup>(1) Transcontinental Gas Pipe Line Corp., 23 FERC ¶ 61,199 (1983) (letter order approving uncontested rate settlement containing SMP), 23 FERC ¶ 61,221 (1983) (amending certificates and authorizing limited-term and pregranted abandonment), 23 FERC ¶ 61,460 (same, for Transco gas acquisition affiliate), *reh. denied*, 24 FERC ¶ 61,052 (1983), *amended*, 25 FERC ¶ 61,219 (1983) (imposing conditions on SMP), *clarified and reh. granted for purpose of further consideration*, 25 FERC ¶ 61,402 (1983), *modified*, 26 FERC ¶ 61,029 (1984) (modifying conditions), *appeal filed*, Columbia Gas Transmission Corp. v. FERC, No. 84-4040 (5th Cir. filed Jan. 18, 1984).

(2) Columbia Gas Transmission Corp., 25 FERC ¶ 61,220 (1983) (approving SMP subject to conditions), *clarified and reh. granted for purpose of further consideration*, 25 FERC ¶ 61,401 (1983), *clarified and reh. denied*, 26 FERC ¶ 61,031 (1984) (modifying conditions), *appeal filed*, Maryland People's Counsel v. FERC, No. 84-1019 (D.C. Cir. filed Jan. 17, 1984).

(3) Tennessee Gas Pipeline Co., 25 FERC ¶ 61,398 (1983) (amending certificates and authorizing limited-term and pregranted abandonment, and approving SMP with conditions), *reh. granted for purposes of further consideration*, Docket No. CP83-502-001 (Feb. 16, 1984), *modified and reh. denied*, 26 FERC ¶ 61,381 (1984) (modifying conditions).

(4) PanMark Gas Co., 26 FERC ¶ 61,341 (1984) (modifying settlement and approving SMP).

In addition, several applications to the Commission for approval of SMPs are pending. *See, e.g.*, Natural Gas Pipeline Company of America, Docket No. CP84-1-000 (filed Oct. 3, 1983); Texas Eastern Transmission Corp., Docket No. CP84-244-000 (filed Feb. 16, 1984); Northwest Pipeline Corp., Docket No. CP84-294-000 (filed Mar. 12, 1984); Cities Service Oil and Gas Corp., Docket No. CI84-332-000 (filed Mar. 5, 1984).

<sup>118</sup>Tenneco Oil Co., 25 FERC ¶ 61,234 (1983) (issuing certificates, authorizing limited-term abandonment and approving SMP subject to conditions), *reh. granted for purpose of further consideration*, 25 FERC ¶ 61,419 (1983), *reh. granted in part and denied in part*, 26 FERC ¶ 61,030 (1984) (modifying conditions), *appeal filed*, United Texas Transmission Corp. v. FERC, No. 84-1024 (D.C. Cir. filed Jan. 23, 1984).

<sup>119</sup>The most recently approved SMP differs from the general rule stated in the text. Under the SMP established by Panhandle Eastern Pipe Line Company and Trunkline Gas Company, a newly created corporate entity, PanMark Gas Company, will take title to gas released by Panhandle, Trunkline or other pipelines, and resell it to distributors or end-users. *See* PanMark, *supra* note 117.

from the producers by designated eligible customers, at a price set by the pipeline. The price is changed from time to time, but at any given time it is the same for all producers that can lawfully charge it; gas subject to a price ceiling lower than the posted price is purchased at the ceiling price. This posted price is designed to make the gas marketable at the burnertip after adding the cost of transporting it through the pipeline and distribution companies' system. The pipeline then transports the gas to its purchasers.

Under a contract carriage program, the pipeline's role is more passive. It does not create a pool of available gas. Purchasers must find producers willing to sell to them. Nor does the pipeline establish the price. In essence, in a CCP the pipeline makes itself available as a transporter.

This description of SMPs is a snapshot of a changing pattern. The distinction between an ISP and a CCP is not like the distinction between transportation under the Order No. 533 program and transportation under Order No. 27. That earlier distinction was clearly a product of the Commission's policies and rules; some transportation qualified under one program and some transportation under the other. Commission policies have also helped to shape some of the distinctions between the kinds of SMPs, but those distinctions are principally a product of business decisions by the pipelines (and the one producer) that have established the programs. The categories described above are useful for discussions, but new business decisions may blur the distinctions or create new categories.

The SMPs had their origin in an uncontested settlement of a Transcontinental Gas Pipe Line Corporation ("Transco") rate case, approved by the Commission in April 1983.<sup>120</sup> The Transco program included both an ISP and a CCP. Both were well received. By the end of January 1984, Transco had transported about 25.8 Bcf of gas under its ISP and 41.1 Bcf under its CCP.<sup>121</sup> About three-quarters of that gas was from Transco's on-system supplies; on average, it was sold under the programs at 43.4 cents per Mcf less than Transco's contract prices.<sup>122</sup>

By the fall of 1983, programs modelled more or less closely on Transco's were proposed by several pipelines and by one major producer, Tenneco Oil Company ("Tenneco").<sup>123</sup> In November the Commission issued orders approving special market programs for Columbia Gas Transportation Corporation ("Columbia") and Tenneco and revising the rules governing Transco's programs;<sup>124</sup> an order approving a program for Tennessee Gas Pipeline Company ("Tennessee") was issued in December 1983 and for Panhandle Eastern Pipe Line Company and Trunkline Gas Company ("Panhandle/Trunkline") in March 1984.<sup>125</sup>

These orders embodied two major decisions. One was procedural. The orders approving the special marketing programs can be viewed as ad hoc blanket certificates: once the orders were issued, transactions falling within their terms could be undertaken without prior Commission approval. There remained, however, the question of issuing the orders themselves. The Transco program had, as noted, originally been established by an uncontested settlement. But the other programs were opposed by one or more parties. If the programs had been set for hearing, they

<sup>120</sup>*Supra* note 117, 23 FERC ¶ 61,199.

<sup>121</sup> Application of Transcontinental Gas Pipe Line Corporation and Transco Gas Supply Company on Behalf of Producer—suppliers to Extend Term of Authorization and Request for Expedited Consideration, Docket No. CP83-279, *et al.*, at 4 (filed Mar. 2, 1984).

<sup>122</sup> Transco estimates that, as a result, the cost of gas for its customers was \$21 million less than it would have been had contract prices been paid and that, for the summer of 1983, Transco's potential take-or-pay obligations were reduced by about \$150 million. *Id.*

<sup>123</sup>*Supra* notes 117-18.

<sup>124</sup>*Id.*

<sup>125</sup>*Supra* note 117.

probably would have been delayed at least until late 1984. In the orders approving the programs, the Commission held that a hearing was not required.<sup>126</sup>

The second decision was to impose a generally uniform set of conditions on the programs. These conditions were further refined in the orders on rehearing issued for Transco, Columbia and Tenneco on January 16, 1984 and for Tennessee on March 23, 1984.<sup>127</sup> Similar conditions were imposed on the Panhandle/Trunkline SMP on March 19, 1984.<sup>128</sup> The conditions do vary from one program to another. However, the similarities are generally more important than the differences.

A number of limitations on the SMPs affect their attractiveness as vehicles for direct producer sales. First, the Commission has required that the weighted average cost of the gas ("WACOG") released by the pipeline for sale in the program be at least as high as the weighted average cost of gas bought by the pipeline as a whole. This WACOG requirement is applied to the price that the pipeline would have been contractually obligated to pay for the gas if it had purchased the gas rather than releasing it. The Commission has also generally required that no gas may be sold under an SMP unless its price prior to release is more than the maximum lawful price allowed by section 109 of the NGPA.<sup>129</sup> Thus, not only must the average cost of the gas released for sale exceed WACOG; the cost of each unit of gas must exceed the section 109 price. These requirements are intended to ensure that the program "will not operate to siphon low-priced supplies from pipeline system supplies."<sup>130</sup> Such a siphoning would mean that purchasers of gas from a pipeline's system supplies would be subsidizing those purchasing from the pool of surplus gas. The requirements thus should mean that the reductions in price necessary to make the surplus gas attractive to eligible customers will come, if at all, as a result of price concessions by the producers of the gas. By allowing the retention of low-cost supplies for pipeline system supply while permitting the higher-cost supplies to be sold elsewhere, these conditions also should lower the cost of system supply.

Second, only gas contractually committed to a pipeline or a local distribution company at the time the Commission approves the SMP may be sold under the SMP.<sup>131</sup> This requirement is intended to ensure that sales under an SMP help a pipeline solve the problem of having contracted to buy more gas than it presently can sell by conventional means.

Third, and particularly significant for the purposes of this article, is the limitation that only certain distributors and end-users can buy gas under an SMP. Originally, the SMPs were limited by the Commission to serving new loads, or loads that would otherwise be served by alternative fuels, producer direct sales

<sup>126</sup> Columbia, *supra* note 117, 26 FERC ¶ 61,031 at 61,081-84; PanMark, *supra* n.117, slip op. at 2; Tenneco *supra* n. 118, 26 FERC ¶ 61,030 at 61,064-67; Tennessee, *supra* note 117, 25 FERC ¶ 61,398 at 61,888.

<sup>127</sup> *Supra* notes 117 and 118.

<sup>128</sup> *Supra* note 117.

<sup>129</sup> E.g., Tenneco, *supra* note 118, 25 FERC ¶ 61,234 at 61,607 (ordering paragraphs G and H).

<sup>130</sup> *Id.* at 61,605-06.

<sup>131</sup> *Id.* at 61,607 (ordering paragraph L).

arrangement, other gas marketing programs, or by off-system sales.<sup>132</sup> The Commission's aim was to enable a pipeline sponsoring an ISP to retain or regain its marginal markets by charging lower rates to customers that otherwise might switch to other fuels, or that might use natural gas only where there are special price considerations. The SMPs thus are designed, like blanket certificates, to stimulate consumption by creating competitive forces that should drive down the price.<sup>133</sup> The lower rates, the Commission anticipated, would result from enhanced price competition among producers anxious to sell the gas released by the pipeline.<sup>134</sup> At the same time, however, the Commission was concerned about loss of pipelines' "core markets," and thus severely restricted the opportunities for pipelines to compete against each other for customers — so-called "gas-for-gas" competition.<sup>135</sup> More recently, however, the Commission expanded the class of eligible purchasers by also allowing the ISPs to compete for service provided under interruptible service schedules.<sup>136</sup> Even with this expansion, however, the class of eligible purchasers under an ISP remains far more restricted than it is under a blanket certificate, where a pipeline may transport direct-sale gas for *any* end-user.<sup>137</sup>

It is interesting to compare the SMPs — the Commission's latest programs permitting transportation for direct sales — with Order No. 533, the first such program. Order No. 533 was designed to increase supply to the interstate market by allowing certain end-users to bid gas away from the intrastate market; that is, to use direct sales to transmit price signals to the wellhead. The SMPs also aim to use direct sales to transmit price signals to the wellhead. At the time of Order No. 533, end-users' demand for gas exceeded the supply; the Commission hoped that increased supply would be forthcoming from producers as a result of higher prices. Now, with a surplus of gas available in the interstate market, it is hoped that producers will seek to increase demand by lowering prices.

There is a striking similarity between these two regulatory endeavors: each seeks to reach a desirable goal by bypassing the interstate pipelines' traditional role as natural gas marketers. In the case of Order No. 533, the pipelines were bypassed because the prices they were allowed by the Commission to pay for gas were too low to enable them to attract sources of supply. Today, the pipelines are again being bypassed, this time because the result of the combined effect of their rolled-in pricing and high take-or-pay obligations is prices that are too high to enable them to retain their existing sources of demand.

<sup>132</sup>For example, the order approving Tenneco's marketing program ("Tenneflex") states:

Any gas sold under Tenneflex to distributors or end-users which are served, directly or indirectly, by any pipeline (provided that no tariff provision prevents the sale) shall be limited to new loads not previously served by natural gas, or to requirements which are being or would otherwise be served by:

- (1) alternative fuels;
- (2) producer direct sales arrangements;
- (3) gas made available under industrial sales programs or other similar sales programs;
- (4) gas sold by pipelines under special discount rates, or in off-system sales; or
- (5) propane or synthetic natural gas.

*Id.* at 61,607-08 (ordering paragraph M).

<sup>133</sup>Notice of Inquiry, *Impact of Special Marketing Programs on Natural Gas Companies and Consumers*, Docket No. RM84-7-000, 26 FERC ¶ 61,033 (Jan. 16, 1984), 49 Fed. Reg. 3193 (Jan. 26, 1984) (mimeo ed. at 13).

<sup>134</sup>Transco, *supra* n. 117, 26 FERC ¶ 61,029 at 61,053.

<sup>135</sup>*E.g.*, Columbia, *supra* note 117, 25 FERC ¶ 61,220 at 61,562.

<sup>136</sup>*E.g.*, Columbia, *supra*, note 117, 26 FERC ¶ 61,031 at 61,091 (ordering paragraph G).

<sup>137</sup>18 C.F.R. § 157.209.

*c. 1982-1984: A summary*

Of the four programs that had been established during the 1975-1979 period, one was abolished. Order 30 was finally terminated on November 5, 1983. It was, however, effectively replaced by the new blanket certificate rules. Those new rules in general are more liberal than Order 30. The exception is their greater vulnerability to protests. For transportation that fit its terms, Order 30 allowed self-implementing transportation to end-users for any period during the fuel shortage emergency period without regard to protests. The blanket certificate rules allow self-implementing transportation for a longer period,<sup>138</sup> but, except for high-priority end-users, the transportation may be halted after 120 days pending the completion of a hearing if a protest is filed and not withdrawn.

Two other programs remain on the books but probably are now effectively irrelevant. The Order No. 533/Order No. 2 statement of policy nominally continues to be in force, but there are few if any circumstances in which parties would rely on that policy in preference to the procedures of the blanket certificate rules. The same appears to be true of the rules issued in Order No. 27.

Of the programs established in the earlier period, only the section 311 transportation rules continue to be in force and relevant. They now coexist with the transportation rules of the blanket certificate program and the SMPs. The next part of this section provides a framework for analyzing which of these three programs — section 311, blanket certificates, and SMPs — is available to provide transportation for various categories of direct producer sales.

*B. The Limits of the Practical – The Present Legal Framework*

Direct producer sales involve, by definition, separate sales and transportation transactions. Often, they also are short-term. Unless they can commence soon after negotiations are concluded, the commercial opportunity is likely to vanish. The practical problem posed by direct producer sales therefore is to structure the transactions so that neither the sale nor the transportation requires prior administrative approval. For the sale, this generally is done by avoiding federal jurisdiction altogether. In general, direct producer sales are not made where the sale itself would be subject to federal regulation. Some of the sales under the SMPs are the principal exception.

If the sale is limited to the intrastate market, federal regulation of the transportation can also be avoided. Within the interstate market, however, federal transportation regulation is inescapable. Federal regulation is not, however, the same thing as prior administrative approval. It is possible to avoid the latter by qualifying for one of the self-implementing procedures described in the preceding section.

<sup>138</sup> 18 C.F.R. § 284.205(c) (1983) (Order No. 30); 18 C.F.R. § 157.209 (blanket certificates.)

The field of practical direct producer sales in the interstate market therefore can be thought of as the intersection of two circles, as illustrated below. One circle includes all sales that are not subject to federal jurisdiction, plus some additional sales that have been approved under an SMP. The other circle includes all of the self-implementing transportation programs. The field of practical direct producer sales is the shaded area where the two circles overlap: the area where the sale itself is not regulated or has been approved in an SMP, and the gas sold can be transported under a self-implementing procedure.

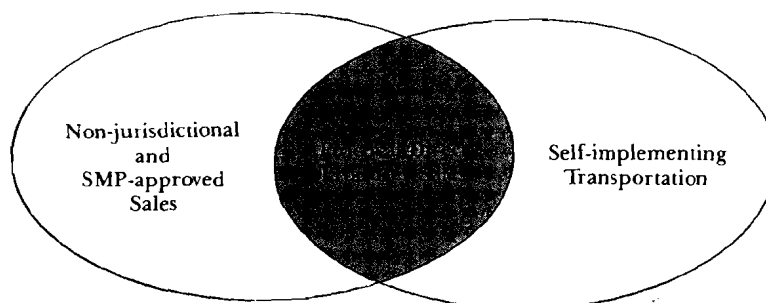


Figure 1

1. Regulation of the sale

a. Dedicated gas

Under the NGA, a sale of gas that is dedicated to interstate commerce cannot be abandoned without the Commission's approval.<sup>139</sup> While the term "dedicated" nowhere appears in the NGA, dedication became the central legal concept by which the Commission enforced wellhead price controls on natural gas in the interstate market. Not surprisingly, it pervades the case law.<sup>140</sup> Dedicated gas had to be sold in the interstate market no matter what price it could have fetched in the unregulated intrastate market.<sup>141</sup>

The enactment of the NGPA released only certain categories of already-dedicated gas from the Commission's jurisdiction under the NGA.<sup>142</sup> All other dedicated gas remains dedicated. Indeed, gas that was not yet dedicated when the NGPA was enacted, but was at that time contractually committed to be sold in interstate commerce, becomes dedicated when so sold, even after enactment of the NGPA.<sup>143</sup>

Accordingly, dedicated gas cannot be sold in a direct sale if the Commission certificate under which it is dedicated requires it to be sold elsewhere. This requirement effectively bars direct producer sales of such gas using only the section 311 or blanket certificate transportation programs. It does not bar direct producer sales under an SMP: In its order approving an SMP, the Commission authorizes abandonment of the producer-pipeline sales required by the producers' certificates

<sup>139</sup>NGA § 7(b), 15 U.S.C. § 717f(b) (1982); see *United Gas Pipe Line Co. v. FPC*, 385 U.S. 83, 85-88 (1966); see generally Conine & Niebrugge, *supra* note 9.

<sup>140</sup>See, e.g., *United Gas Pipe Line Co. v. McCombs*, 442 U.S. 529 (1979); *California v. Southland Royalty Co.*, 436 U.S. 519 (1978); *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137 (1960); *Mitchell Energy Corp. v. FERC*, 651 F.2d 414 (5th Cir. 1981); *Harrison v. FERC*, 567 F.2d 308 (5th Cir. 1978).

<sup>141</sup>*Supra* note 8.

<sup>142</sup>*Infra* text at notes 145-46.

<sup>143</sup>*Infra* note 145.

and authorizes direct sales of the gas.<sup>144</sup> This advantage may be a major reason for seeking approval of an SMP rather than relying on one of the other two programs.

*b. Gas that is neither committed nor dedicated*

At the other extreme from gas that continues under the Commission's jurisdiction is gas that will never be subject to that jurisdiction under existing law. The NGPA provides that gas that was neither contractually committed, nor dedicated, to interstate commerce at enactment of the NGPA will not become subject to NGA jurisdiction even if it is sold, by someone other than a wholesaling pipeline, in interstate commerce.<sup>145</sup> The sale of such gas thus is not subject to regulation by the Commission.

This gas, while not dedicated to interstate commerce, may now be contractually committed to an interstate pipeline. Its release from contract by a pipeline is subject to the Commission's scrutiny on the basis of whether it was prudent. The release of such gas by the pipeline, so that it may be sold in a direct sale, is part of what the SMPs have permitted.

*c. Gas that once was committed or dedicated but which has been freed*

Between the two categories just described lies a third: gas that was either contractually committed, or dedicated, at enactment of the NGPA, but which has become freed from the Commission's NGA jurisdiction by operation of the NGPA.<sup>146</sup>

<sup>144</sup>E.g., Columbia, *supra* note 117, 25 FERC ¶ 61,220 at 61,566 (ordering paragraph Q).

<sup>145</sup>NGPA § 601(a)(1)(A), 15 U.S.C. § 3431(a)(1)(A) (1982). This provision requires that the gas have been neither committed nor dedicated at the enactment of the NGPA. Thus, gas which was contractually committed to interstate commerce, but not dedicated, will become dedicated when sold in interstate commerce in a first sale.

The NGPA defines "committed or dedicated to interstate commerce" to mean:

"(i) natural gas which is from the Outer Continental Shelf; and  
(ii) natural gas which, if sold, would be required to be sold in interstate commerce (within the meaning of the Natural Gas Act) under the terms of any contract, any certificate under the Natural Gas Act, or any provision of such Act."

NGPA § 2(18)(A), 15 U.S.C. § 3301(18)(A) (1982). The definition then goes on to exclude a number of categories of gas. For the purposes of this article, it is interesting to note that the definition excludes from being committed or dedicated:

"(i) natural gas sold in interstate commerce . . .

(IV) to the user by the producer and transported under any certificate, granted pursuant to Section 7(c) of the Natural Gas Act, if such certificate was specifically granted for the transportation of that natural gas for such user . . ."

*Id.* § 2(18)(B), 15 U.S.C. § 3301(18)(B) (1982).

<sup>146</sup>NGPA § 601(a)(1)(B), 15 U.S.C. § 3431(a)(1)(B) (1982), states that gas falling into certain categories, which was committed or dedicated at enactment of the NGPA, shall not be subject to the Commission's NGA jurisdiction when it is sold in interstate commerce in a first sale. Those categories are: high-cost natural gas, as defined in NGPA § 107(c) (1)-(4); new natural gas, as defined in NGPA § 102(c); and natural gas produced from any new, onshore production well, as defined in NGPA § 103(c).

Like gas that was never committed or dedicated, this gas can be released without prior Commission approval; its release is subject only to a potential later inquiry into prudence. The fact that the gas was once committed or dedicated is, however, relevant to direct producer sales in two respects. When the contract committing this type of gas to a pipeline expires, the pipeline generally must be given a right of first refusal to continue to purchase it.<sup>147</sup> And, as will be seen, the earlier commitment or dedication may also affect the purchaser's ability to have the gas transported.

## 2. Regulation of the transportation

As the earlier historical survey shows, the Commission's programs authorizing transportation for direct producer sales came into existence at different times and for different reasons. Three major transportation programs now co-exist: Section 311, blanket certificates and the SMPs. This section describes the differences and similarities between these programs from the point of view of an end-user or local distribution company interested in a direct purchase of some natural gas. The Order No. 533 and Order No. 27 programs are not included in this comparison; since any transportation authorized under them is also authorized by a blanket certificate, it is assumed that the latter — procedurally a simpler mechanism — would be used.

Four factors are important in determining whether transportation is authorized by any of the three programs. First, can the gas that is to be sold be transported under the program? ("What gas?") Second, are there any restrictions on the price that the purchaser can pay for the gas? ("What price?") Third, is the purchaser eligible to have the gas transported to it? ("Which purchasers?") And fourth, are the procedural requirements complex or simple, time-consuming or brief? ("What procedures?")

<sup>147</sup>NGPA § 315(b), 15 U.S.C. § 3375(b) (1982); Bona Fide Offers; Right of First Refusal, Order No. 95, Docket No. RM80-8, [Reg. Preambles 1977-1981] FERC Stat. & Reg. ¶ 30,179 (1980), 45 Fed. Reg. 53116 (1980) (codified at 18 C.F.R. Part 277, Subpart B (§§ 277.201-277.210)), *reh. granted for purposes of further consideration* (Sept. 24, 1980).



a. *What gas?*

(i.) *Section 311 of the NGPA*

Neither section 311 itself nor the Commission's regulations authorizing transportation under it limit the gas eligible for transportation. But, of course, gas that is committed or dedicated to interstate commerce under a Commission certificate can be sold only to the purchaser named in the certificate. Before it can be sold to anyone else, an application for abandonment would have to be made to and approved by the Commission. The transaction as a whole — sale plus transportation — thus could not be carried out without prior approval by the Commission.

On the other hand, gas that was committed or dedicated at enactment of the NGPA, but which is now freed of the Commission's jurisdiction by the NGPA, may be sold without prior Commission approval and transported under section 311. So, of course, may gas that never was committed or dedicated.

(ii.) *Blanket certificates*

Under a blanket certificate, gas available for transportation is determined by a different criterion: it must not have been committed or dedicated on the day before enactment of the NGPA.<sup>148</sup> Thus, gas committed or dedicated on that date, but subsequently freed, is *not* eligible to be transported under a blanket certificate.

(iii.) *SMPs*

SMPs divide up the world of gas in yet another way. Only gas that is under contract to a pipeline or a local distribution company on or before the day an SMP is approved may be released and transported under that SMP. Some of this gas, of course, may well be dedicated gas still subject to the Commission's jurisdiction. That is why each Commission order establishing an SMP grants limited abandonment of the producers' service to the pipeline, and amends their certificates to authorize them to sell the gas directly to purchasers eligible under the SMP.<sup>149</sup> It also grants the pipeline a certificate authorizing it to transport the gas for the purchasers.<sup>150</sup>

<sup>148</sup>*Supra* text at note 104.

<sup>149</sup>*Supra* note 144.

<sup>150</sup>*Id.* at 61,564 (ordering paragraph A).

*b. What price?*

*(i.) Section 311 of the NGPA*

Neither section 311 nor the Commission's regulations implementing that provision impose any limit on the price that can be charged by a producer to the purchaser for gas whose transportation is authorized under section 311. Of course, the NGPA itself limits the maximum price that lawfully can be paid in first sales of all categories of gas whose price is not unregulated. Any sale to an end-user other than by a pipeline or a local distribution company will be a first sale, so that all direct producer sales of price-regulated gas will be subject to NGPA ceiling prices. But because direct producer sales presumably will be attractive only when the price at which the gas is offered is discounted, the NGPA's maximum lawful prices probably will not be a constraint on direct producer sales employing section 311 transportation.

The SMP orders generally contain a provision conditioning section 311 transportation, by a pipeline with an SMP, of any released gas on its meeting the price (and other) standards applied to determine the gas' eligibility for sale under the SMP.<sup>151</sup> In other words, the average price must be at least equal to the pipeline's weighted average cost of gas and the price of all gas must exceed the NGPA Section 109 price.

*(ii.) Blanket certificates*

As with section 311 transportation, the only price constraint is the NGPA's maximum lawful prices.

*(iii.) SMPs*

As noted above, each order approving an SMP has required that the WACOG of the gas released for sale and transportation under the SMP be at least as high as that of the pipeline as a whole, and that each unit of released gas be priced before release above the NGPA section 109 price.<sup>152</sup>

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<sup>151</sup>*Id.* at 61,566 (ordering paragraph T).

<sup>152</sup>*Supra* note 129.

Figure 2 illustrates what gas can be transported under each program, taking into account the WACOG pricing standard imposed on SMPs and on section 311 transportation, by a pipeline with an SMP, of released gas.

Transportation Availability by Type of  
Gas, Price and Contract Status

	SMP	SMP 311	SMP 311 Blankets	
Above WACOG				Under contract on date of SMP
Below WACOG	Not Available	311 (except released gas)	311 (except released gas) Blankets	
Above WACOG	Not Available	311 (except released gas)	311 (except released gas) Blankets	Not under contract on date of SMP
Below WACOG	Not Available	311 (except released gas)	311 (except released gas) Blankets	
	Committed or dedicated on 11/8/78 and not freed	Committed or dedicated on 11/8/78 and freed	Not committed or dedicated on dedicated on 11/8/78	

Figure 2

c. Which purchasers?

(i.) Section 311 of the NGPA

As discussed above, the Commission's general section 311 regulations require that transportation under that provision be for the "system supply" of a local distribution company. But, as noted, it may be possible to structure an arrangement with a local distribution company that functionally is almost indistinguishable from a direct sale to an end-user.<sup>153</sup> For the purpose of simplifying the following figures, it is assumed, however, that section 311 transportation is not available for an end-user.

<sup>153</sup>Supra notes 59-67.

(ii.) *Blanket certificates*

At least until June 30, 1985, all end-users are eligible to receive transportation under a blanket certificate.<sup>154</sup> Local distribution companies are also eligible to receive transportation under a blanket certificate.<sup>155</sup>

(iii.) *SMPs*

As discussed above, the Commission has imposed strict limits on eligibility to purchase under a SMP, in order to protect pipelines' "core markets" from gas-to-gas competition. Eligibility to purchase is defined in terms of past non-use of gas; of potential use of alternative fuels or non-traditional gas supplies; or of rights to interruptible services.<sup>156</sup> Figure 3 illustrates which purchasers are eligible under which program.

Transportation Availability by Type of Purchaser

	SMP-eligible purchaser	Non-SMP-eligible purchaser
Local Distribution Company	SMP 311 Blankets	311 (but not released gas) Blankets
End-user	SMP Blankets	Blankets

Figure 3

d. *What procedures?*

In structuring an individual direct sale transaction, it may be very important to determine what procedures are necessary to obtain authorization. Indeed, the relative ease of obtaining authorization may be the factor determining which transactions are entered into. Can the transportation required be undertaken without prior Commission approval under section 311 or a blanket certificate? Or will neither of these apply, meaning either that approval for an SMP or the issuance of a regular section 7 certificate will have to be sought? Figure 4 illustrates the available possibilities.

<sup>154</sup> 18 C.F.R. § 157.209.

<sup>155</sup> 18 C.F.R. § 157.209(b)(3)(i).

<sup>156</sup> *Supra* notes 132-36.

Transportation Availability by Type of Purchaser,  
SMP Eligibility and Authorization

Local distribution company		High-Priority End-User		Other End-User		
311	311	Blanket-if for less than 5 years	Blanket-if for less than 5 years	Blanket-if for less than 120 days	Blanket-if for less than 120 days	Automatic Authorization
Blanket	Blanket	Blanket-if for more	Blanket-if for more	Blanket-if for more	Blanket-if for more	Notice-and-Protest Procedure
SMP	N/A	SMP	N/A	SMP	N/A	SMP Required
SMP-Eligible	Not SMP-Eligible	SMP-Eligible	Not SMP-Eligible	SMP-Eligible	Not SMP-Eligible	

Figure 4

If Figures 2 and 4 could be combined, it would be possible to read off whether transportation is available under each program for every combination of:

- Gas
- Price
- Contract status of gas
- Type of purchaser
- SMP-eligibility of purchaser
- Available procedures

Unfortunately, illustrating the interplay of these six variables is difficult, if not impossible, in two dimensions! But different variables may usefully be tabulated together. For example, it is interesting to consider transportation availability in terms of the type of purchaser, eligibility to purchase under an SMP, and type of gas. These are illustrated in Figure 5.

Transportation Availability by Type of Purchaser,  
SMP Eligibility and Type of Gas

	Local Distribution Company		End-User	
	SMP	Not available	SMP	Not available
	SMP 311	311 (except for released gas)	SMP	Not available
	SMP 311 Blankets	311 (except for released gas) Blankets	SMP Blankets	Blankets
Committed or dedicated or 11/8/78 and not freed				
Committed or dedicated on 11/8/78 and freed				
Not committed or dedicated				
	SMP-Eligible	Not SMP-Eligible	SMP-Eligible	Not SMP-Eligible

Figure 5

## II. THE FUTURE OF DIRECT PRODUCER SALES

Two things are necessary if direct producer sales are to continue to grow or even to maintain their present importance in the interstate market. One is pipeline transportation. Possibly that transportation will be provided willingly. If not, the further development of direct producer sales will depend on pipelines' being subject to an effective legal obligation to transport producers' gas willingly or not.

The second thing required is that direct producer sales have a significant economic role. Direct producer sales are an alternative to sales from pipeline system supply. Unless they offer some advantage over pipeline sales, they will not be made even if transportation is readily available. Producers and purchasers will prefer to deal with a pipeline rather than directly with each other.

### *A. Availability of Pipeline Transportation*

#### *1. Obtaining transportation under the blanket certificate or section 311 rules*

The new legal rules discussed in the first section of this article largely have removed two obstacles to pipeline transportation of direct producer sale gas. The Commission no longer generally opposes such transportation as a matter of policy; indeed, by their terms the Commission's blanket certificate rules are expressly designed to facilitate it. For many transactions the blanket certificate rules and those issued under NGPA section 311 also eliminate what might be called pure bureaucratic delay — delay not caused by any substantive concerns but due to the time required to complete required procedures.

Two vestiges of Commission opposition and delay remain and may be significant in some cases. The Commission's special marketing program orders prefer direct producer sales of gas released from system supply over direct sales of gas not committed to any pipeline; this preference reflects the take-or-pay difficulties confronting some pipelines. And procedural delay is still a problem for direct producer sales not qualifying for any of the self-implementing procedures. Direct sales of Outer Continental Shelf gas to end-users is the most important category excluded from both blanket certificates and section 311. It can be transported under the special marketing programs (SMPs) approved by the Commission; this may in fact be one of the principal reasons for a pipeline to seek approval of such a program despite the conditions that the Commission attaches to its approval. If transportation under an SMP is not available, however, transportation to the end-user must still be authorized by an individual section 7 certificate, unless transportation under a blanket certificate may be employed.

#### *a. Contested applications*

Generally, the most important remaining obstacles to transportation of direct producer sale gas do not, however, stem directly from Commission policies or procedures but from the opposition of parties outside the Commission: from other gas sellers who would compete with the sale, and from the pipeline requested to provide the transportation. Transportation under the blanket certificate rules is self-implementing only for 120 days. Beyond that period, a hearing may be required if protestors oppose the transportation. If the hearing is not completed within the 120-day period, the sale must be suspended until the hearing is completed and the sale approved.

The practical effect of this hearing requirement depends on four factors: (1) the frequency with which parties protest against blanket certificate transportation;

(2) the proportion of the protests that result in hearings; (3) the length of the hearings; and (4) the speed of the Commission's decisionmaking process after a hearing is completed. The Commission's experience in the first months under the rules suggests that protests will not be common. At the beginning of February 1984 nearly one hundred notices had been filed but protests were outstanding in only four cases.<sup>157</sup>

A protest does not necessarily require a hearing. It does so only if the protest raises a material issue of fact, and what is material depends on the substantive standards that the Commission applies to transportation proposed under the blanket certificate rules.<sup>158</sup> To this extent, the Commission has some ability to increase or decrease the likelihood that protestors will be able to demand a time-consuming hearing. The limit on the Commission's ability to do this stems from the gloss that courts have placed on the hearing requirement imposed by section 7(c).<sup>159</sup>

At the time of this writing no hearing had yet commenced under the blanket certificate rules, but experience with other section 7 hearings suggests that the delay caused by a hearing and by post-hearing procedures may be quite substantial — probably a year or more.

The pattern that appears to be emerging under the new blanket certificate rules is consistent with the Commission's experience with pipeline off-system sales. In general, protests of those sales came from two sources: on-system customers who asserted that the sale would eventually raise their gas costs, and other pipelines with which the sale would compete. Protests by on-system customers have been relatively common, while protests by competing pipelines have been made in only a small percentage of the cases. Conventional direct producer sales do not arouse the wrath of on-system customers in the same way that pipeline off-system sales do.<sup>160</sup> Protests of blanket certificate transportation of direct producer sale gas therefore can be expected to come principally from competing gas sellers. Such protests are likely to be made in only a few cases, but in those cases they may constitute a substantial obstacle.

#### *b. Unwilling pipelines*

The most significant source of opposition, however, is likely to come not from affected third parties but from the pipeline that is requested to carry the gas. That pipeline may, to put it baldly, simply refuse to transport.

<sup>157</sup> Information provided by the Office of Pipeline and Producer Regulation, FERC.

<sup>158</sup> For example, the Commission might take the position, as it did in denying in the SMP orders that a hearing was necessary, that where the controversy to which the protest relates arises out of conflicting predictions about the impact of the proposed transportation, no hearing is necessary. *Supra* n.126.

<sup>159</sup> *Id.*

<sup>160</sup> However, direct producer sales of gas released by a pipeline may do so if the entire transaction — the release by the pipeline followed by the producer's sale of gas — is considered together. The transaction still generally does not affect other customers immediately, since the sale does not enter into their average gas costs, but the future effect of the transaction on those customers generally is the same as if the pipeline itself had sold the gas: prepayment carrying charges will be less, and more gas will be purchased at replacement cost than at the (either higher or lower) price determined by the contract governing the released gas.

Pipelines are not in general unwilling to transport gas for others. Such transportation has increased markedly over the past decade.<sup>161</sup> But the "other" for which pipelines transport gas is in most cases another pipeline.<sup>162</sup> The major interstate pipelines were constructed to link producing areas with major markets. Initially, all or nearly all the gas needed to serve each pipeline's markets could be obtained from producing areas near its own lines. Growth in demand and the decline of old producing areas have, however, required pipelines to look far from their own transmission systems for sources of supply.

The means used to obtain gas from other sources are various. Pipelines in some cases purchase gas from the system supply of other pipelines. There may then be no transportation for others: The gas at all stages may belong to the pipeline that is carrying it. But in other cases a pipeline may itself acquire gas in distant supply areas and rely on other pipelines to move the gas to its own system. Or a pipeline may enter into a joint venture to build a major new pipeline to transport gas from new producing areas; the High Island Offshore System in the Gulf and the Trailblazer system onshore are major examples. In these latter cases, the gas is transported part of the way between wellhead and burnertip by a pipeline that does not own the gas. But the gas is still controlled by the pipeline that finally receives it before selling it to a distributor or end user.

A recent Energy Information Administration study of pipelines with large volumes of gas transported for others found that in 1982, 56% of the transportation was for other interstate pipelines and 32% was for corporate affiliates.<sup>163</sup> All other shippers — intrastate pipelines, local distribution companies, end users, independent marketers — accounted for only 12 percent of the total volume.

Transportation for affiliates and other pipelines is important for an efficient national market, but it has little or nothing to do with direct producer sales. The transportation that one pipeline provides for another generally does not affect the transporting pipeline's own gas marketing. The transporting pipeline generally is upstream of the one that purchases the gas, and the two generally do not compete in city gate or burnertip markets.

Direct producer sales, in contrast, are likely to require transportation by a pipeline that, directly or indirectly, serves the same market. A pipeline that is asked to transport a producer's gas into its own market area has two general kinds of interest in the proposed transaction. The first is an immediate and tangible financial interest. The second is a less tangible interest in its role as gas marketer. The first interest can be readily analyzed, but the second may be the more important determinant of availability of transportation over the long term.

The tangible impact of providing transportation for a direct producer sale in a pipeline's own market area depends on three factors: whether the pipeline would be able to make the sale itself if it refused to transport the gas; the relationship of its transportation tariff to its sales tariff; and its exposure to take-or-pay liability. The significance of the first factor is straightforward. If the pipeline could not make the sale anyway, it is better off receiving transportation revenue than receiving nothing. The pipeline might not be able to make the sale itself because its system supply is too expensive, or because the producer might find another pipeline to transport the gas

<sup>161</sup>See Interstate Natural Gas Association of America, *Natural Gas Carrier Status during the Current Transition: A Critique of Mandatory Contract Carriage* 10-11 (1984). According to this report, based on Energy Information Administration and FERC data, interstate pipeline transportation of gas for others increased from 2.6 Tcf in 1974 to 6.4 Tcf in 1982; as a percentage of all gas transported by those pipelines, the increase was from 9.2 percent to an estimated 17.7 percent.

<sup>162</sup>See *infra* note 163.

<sup>163</sup>Energy Information Administration, *Competition and Other Current Issues in the Natural Gas Market* 73-75 (1984).



to the same market if the first pipeline refuses. The first reason appears to have been important in the interstate market, where it may account for much or most of the pipeline transportation of direct producer sale gas. The second reason probably is more important in the intrastate market, where a denser pipeline network is more likely to provide alternative transportation routes.<sup>164</sup>

If the pipeline itself would otherwise have made the sale, transportation of the direct producer sale gas will not change the pipeline's throughput, but it will result in a shift from sales volume to transportation volume. The impact of such a shift on a pipeline and its customers depends on its transportation and sales tariffs and on its fixed costs. A shift from sales to transportation will of course reduce pipeline gross revenues: A pipeline can charge more for both supplying and transporting gas than it can for transporting it alone. It does not follow that the shift will necessarily affect the pipeline's recovery of its costs, or require that costs be shifted to other customers. The shift will not affect the recovery of truly variable costs so long as those costs are properly allocated to the pipeline service that is causally responsible for them. For example, if variable storage costs are allocated to the pipeline's storage service — including both storage offered as a separate service and storage offered in connection with its sales and transportation services — recovery of those costs will be unaffected by the extent to which customers use the storage service: Storage variable costs and storage revenues will increase or decrease together.

The shift also will not affect recovery of fixed transmission costs provided the pipeline uses a so-called fully-allocated transmission tariff, i.e., one based on system-wide average transmission costs. Such a tariff makes the same contribution to fixed transmission costs as a pipeline's sales tariff; recovery of those costs depends on total throughput and not on the relative proportions of system supply and gas transported for others.

Possibly the shift would affect recovery of fixed storage costs, although it is not clear why a shift from pipeline system supply to other supply sources should make storage any less necessary for the distribution companies and end-users served by a pipeline. Most obviously it would affect recovery of fixed gas acquisition costs. It also may increase those costs if the pipeline is exposed to take-or-pay liability. If the gas is released to the producer from the pipeline's own system supply, take-or-pay relief is likely to be a condition of the release and transportation, and the pipeline's liability will at least be no greater than it would have been without the direct producer sale. Otherwise, however, the shift from sales to transportation will reduce the pipeline's purchases of its own system supply and will increase its potential take-or-pay liability.

Over the long run, it would be possible largely to eliminate any tangible adverse economic impact owing to the shift from sales to transportation. With a better supply-demand balance, moderate reductions in purchases from system supply might not result in potential take-or-pay liability. Changes in pipeline tariffs might, as discussed below, give pipelines reasonable assurance of recovery of other fixed gas acquisition costs. In theory, pipelines should then be indifferent between selling their own gas and transporting producers' gas to their markets.

<sup>164</sup>See D. Mead, *Concentration in the Natural Gas Pipeline Industry* (1981) (draft staff paper, Office of Regulatory Analysis, FERC); American Gas Association, *Competition in the Natural Gas Industry* (1984). The latter study found that most gas in the interstate market is sold by distribution companies served by more than one pipeline. There presumably is, however, generally less competition over routes connecting particular burnertip market-field market pairs. Whether (i) competition to serve field and burner-tip markets individually considered or (ii) competition to serve routes connecting field market-burnertip market pairs is more relevant depends on the nature of the direct producer sale market. To the extent that informational or other barriers limit the range of potential transactions open to a producer, the latter, generally more limited, competition may be the relevant one.

Whether pipelines would in fact be indifferent under those conditions can only be a matter for speculation. There are, however, some grounds for skepticism. So long as pipelines serve as gas marketers as well as gas transporters they will have officers and departments responsible for gas acquisition and sale. Competition from direct producer sales will make the task of planning gas purchasers more difficult because it will make future sales more uncertain, and it will for obvious reasons also complicate the life of the organizational unit responsible for selling the system supply. These departments therefore are unlikely to look favorably on providing transportation that would facilitate competitive direct producer sales.

The views of these departments may not prevail. Some direct producer sales may serve the pipeline's corporate interests.<sup>165</sup> More generally, if there are alternative transportation routes available for the sale, the pipeline may have little choice; if it does not transport the gas, another pipeline will. The extent of effective competition for interstate transportation of gas is uncertain, however.<sup>166</sup> For now at least, it must be assumed that transportation may not be generally available for direct producer sales in the interstate market even when potential take-or-pay liability no longer creates a tangible economic incentive for pipelines to prefer sales from their own system supply. If so, the further development of direct producer sales in that market may depend on whether producers have the legal means to compel unwilling pipelines to transport their gas.

## 2. Compelling transportation

The Commission generally lacks explicit statutory authority to compel the transportation of natural gas.<sup>167</sup> The Commission can require a pipeline to offer service in a nondiscriminatory way under the terms of its generally applicable tariffs. It also can, when initially certificating a jurisdictional service, eliminate or modify conditions of service that limit access to pipeline facilities. It may, for example, modify conditions imposing minimum or maximum terms of transportation service, limiting the number of delivery points, or insisting on individually-negotiated rates for each transaction. It may also require a pipeline to offer storage, transportation, and other services separately, and it may prevent rates that are so high as to make use of an "offered" service prohibitive.<sup>168</sup>

Commission actions of this kind ultimately rest on voluntary pipeline actions. A pipeline may simply not file a general transportation tariff; it may have on file only individual tariffs under which it has undertaken to transport gas for particular

<sup>165</sup> Pipelines may find direct producer sales a useful means of competing with alternative fuels in the boiler fuel market. See *infra* text at note 185. However, direct producer sales for this or similar purposes may consist principally of "captive" sales: ones arranged by the pipeline itself or one of its affiliates.

<sup>166</sup> See *supra* note 164.

<sup>167</sup> Under section 7(a) of the NGA, the Commission may order a pipeline to extend its facilities to serve new wholesale customers, but it cannot compel a pipeline to transport gas for others. See *Chandeleur Pipeline Co.*, 44 FPC 1747 (1970), *aff'd sub nom.* Pub. Serv. Comm. of New York v. FPC, 463 F.2d 824 (D.C. Cir. 1972). See generally Mogel & Gregg, *Appropriateness of Imposing Common Carrier Status on Interstate Natural Gas Pipelines*, 4 Energy L.J. 155, 169-72 (1983) (discussing attempts to include common carriage provisions in the Natural Gas Act).

<sup>168</sup> Blanket certificates, authorizing pipelines to undertake whole classes of jurisdictional activities, raise another issue: May a pipeline holding a blanket certificate seek to limit competition between itself and producers making direct sales, by selectively implementing its blanket authorization? In filing transportation tariff sheets to implement its blanket certificate, one pipeline has filed tariff sheets not permitting transportation if it would result in a reduction in sales by the pipeline. *Columbia Gas Transmission Corp.*, Docket No. RP84-11-001, *et al.*, (filed December 19, 1983). In an unusual step, the Commission itself heard oral argument in this matter on March 7, 1984.

shippers. Similarly, if a pipeline is unwilling to transport gas under the modified terms that the Commission would impose, it can refuse to accept the authorizing certificate.

The Commission does have two possible sources of special authority that are not ultimately dependent on voluntary pipeline action. One is the Outer Continental Shelf Lands Act Amendments of 1978. Section 5 of that statute requires offshore pipelines to transport OCS gas without discrimination and to provide nondiscriminatory access to pipeline facilities to owner and non-owner shippers alike.<sup>169</sup> Section 603 may authorize the Commission to mandate onshore transportation of OCS gas, but neither the Commission nor the courts have squarely addressed this question.<sup>170</sup>

The second possible source is the Mineral Leasing Act, which also requires pipelines traversing federal lands to transport gas produced from such lands without discrimination.<sup>171</sup> To the extent a refusal to transport gas amounts to unlawful discrimination, the Commission may fashion a remedy proscribing the discrimination. Whether in doing so it may order carriage is unclear, since interstate natural gas pipelines are expressly exempted from the common carrier provisions of the statute.<sup>172</sup>

Even if the Commission is powerless to require a pipeline to provide transportation, an end-user or local distribution company denied transportation may seek a remedy under the antitrust laws, alleging that the pipeline is a bottleneck monopolist.<sup>173</sup> The State of Illinois recently filed an antitrust suit against Panhandle Eastern Pipeline Company based on this theory.<sup>174</sup> It would not be surprising if this and similar suits, as well as Commission action, lead to significant development of the law in this area.

The alternative to using existing legal rules to impose a transportation obligation is to enact common carrier legislation. Various common carriage proposals are being debated at the federal level, and at least one state has enacted such legislation.<sup>175</sup> The debate over common (or mandatory contract) carriage raises two broad questions. The first is whether a significant common carriage obligation can be imposed without a serious detrimental impact on pipelines and their customers. The second is whether common carriage is likely to bring substantial benefits to natural gas consumers.

The answer to the first question is yes. It certainly is not difficult to imagine forms of common carriage obligation that would adversely affect pipeline customers, as well as pipelines and distribution companies. Common carriage legislation, like other complex tasks, can be done badly. The most serious consequences, however, are not a necessary byproduct of common carriage.

<sup>169</sup>43 U.S.C. § 1334(f)(1)(A) (1982).

<sup>170</sup>See 18 C.F.R. §§ 284.241-.246 (1983) (Commission statement of policy mandated by Section 603).

<sup>171</sup>30 U.S.C. § 185 (1976).

<sup>172</sup>*Id.* See Mogel & Gregg, *supra* note 167 at 172-74.

<sup>173</sup>See generally Mahinka & Johnson, *New Antitrust Issues in a Deregulated Environment: Access to Pipelines*, 4 Energy L.J. 211 (1983) (evaluating relevance of bottleneck monopoly doctrine to interstate pipelines).

<sup>174</sup>*State of Illinois v. Panhandle Eastern Pipeline Company*, No. 84-1048 (C. D. Ill. filed Feb. 7, 1984).

<sup>175</sup>See Mogel & Gregg, *supra* note 167 at 176-80 (discussing different congressional and state proposals). In 1984, the legislature in New Mexico passed the "New Mexico Natural Gas Price Protection Act." The act deals principally with intrastate price ceilings, but section 7 directs the New Mexico Public Service Commission to "authorize and require the nondiscriminatory transportation of natural gas by any person subject to the jurisdiction of the commission for a seller or purchaser of natural gas to the extent of available capacity."

Pipelines incur costs in order to provide transportation, storage, and gas supply. Pipelines' recovery of those costs depends both on the use made of the services and on the rates that pipelines charge for them. Common carriage would not make a pipeline's transportation and storage services less useful. A pipeline that offered the cheapest means of getting gas to market under the present legal regime would still do so under common carriage; storage that is now economically justified to balance seasonal loads would continue to be economically justified if the pipeline did not own the gas that it transported. If a pipeline's separate transportation and storage charges in its sales rates are equal to the implicit charges for those services in its sales rates, common carriage should not affect its ability to recover the costs of economically efficient transportation and storage facilities, or require the reallocation of those costs to customers who still depend on pipeline system supply. For transportation and storage facilities that are not economic, the question posed is the same under common carriage as under the existing legal regime: How should the burden of investments that have proved not to be economically justified be allocated between ratepayers and investors? Common carriage might pose this question more clearly, but it would not create the question.

Fixed gas supply costs constitute the more serious problem. There are costs incurred merely because the pipeline stands ready to supply a certain volume of gas. The solution to this problem consists of two parts. The first is to recognize that it is a problem: pipelines do incur costs simply in order to make supply available, just as they incur costs simply in order to make transmission capacity available. Prepayment liability is the most obvious of such costs. Prepayment liability could be avoided by negotiating contracts with a very low take-or-pay level, or with no take-or-pay obligation at all, but a pipeline can expect to pay more for gas under such a contract than under one setting a high take-or-pay level. This price premium is not a fixed cost in the conventional sense, but it constitutes part of the cost of having gas available to the pipeline's customers when they want it. Pipeline-owned gathering systems and similar facilities also fall into this category.

The second part of the solution is to devise tariffs that allocate these costs to the customers responsible for them. The responsibility stems from a customer's right to purchase a certain amount of gas; presumably the costs should be allocated on the basis of such rights. Customers who purchase gas in direct producer sales but retain the right to purchase gas from the pipeline therefore impose costs on the pipeline even when they purchase no gas. Such customers should either give up the right or pay for it. Otherwise, the burden of keeping a backup service in readiness for them must fall on other customers of the pipeline.

The immediate answer to the question of the benefits of common carriage is that common carriage can benefit gas consumers by making gas marketing more competitive. Competition does not exist in the abstract, however. It requires real competitors actually on the scene or ready to enter the market if existing sellers leave an opening. One plausible source of competition for pipeline sales is direct producer sales. The relationship between direct producer sales and common carriage thus is a reciprocal one. Common carriage may be essential for the full development of direct producer sales. But the case for common carriage depends in part on the ability of direct producer sales to offer an effective alternative to sales from pipeline system supply.

#### *B. The Economic Role of Direct Producer Sales*

Common carriage would allow gas to be transported from a willing seller to a willing buyer. It would not ensure that producers and customers would in fact find it preferable to deal directly with each other rather than through a pipeline. Even if

transportation is readily available, direct producer sales will continue to be important only if they offer producers some advantage over selling to pipelines and customers some advantage over buying from pipeline system supply.

*1. The present role of direct producer sales*

The present role of direct producer sales is clear. For producers, the alternative to a direct sale may be no sale at all. For customers, direct producer sales often are cheaper than pipeline system supply. The price of gas from pipeline system supply is based on the pipeline's average gas cost. At the end of 1983 the estimated average gas cost of major interstate pipelines was about \$2.93, with individual pipelines ranging from \$2.07 to \$3.63.<sup>176</sup> At the same time, gas reportedly could be purchased from producers in short-term sales at a price as low as \$2.40 in Oklahoma and around \$3.00 in Texas and Louisiana.<sup>177</sup> Direct producer sales therefore could undersell pipeline system supply in many markets if transportation could be arranged at a reasonable rate.<sup>178</sup>

For both producers and customers, the present advantages of direct producer sales are, directly or indirectly, a product of the natural gas surplus. Pipelines have generally been unwilling to contract for new reserves and have reduced takes under existing contracts. Producers therefore have turned to short-term direct sales<sup>179</sup> as an alternative outlet.

Producers' attempts to market their unsold gas have in turn exerted downward pressure on wellhead prices.<sup>180</sup> This downward pressure would not have affected the competitive position of direct producer sales if pipelines' own gas costs were equally responsive to market conditions. But they are not. The only common provision for downward price adjustment is the market-out clause,<sup>181</sup> and it is found in producer-pipeline contracts governing substantially less than half the interstate pipelines' gas supply.<sup>182</sup> As a consequence, the price paid by pipelines for section 102 and section 107 gas is generally higher than the prevailing short-term price, and even section 103 gas is undersold by some short-term sales. For some pipelines this competitive disadvantage is more than offset by a cushion of cheap regulated gas, but for other pipelines it is not.

The advantage of direct producer sales will not last in its present form. The gas surplus will end. Producers will again be able to find pipeline purchasers for their

<sup>176</sup> These prices are taken from the PGA filings of the twenty largest interstate pipelines that were in effect at the end of 1983. Individual pipeline estimated gas costs were weighted by projected sales volumes to derive the average.

<sup>177</sup> Spot and short-term contract prices are reported for several producing areas in the weekly newsletter, *Natural Gas Intelligence*.

<sup>178</sup> Just what is a "reasonable rate" for the transportation of direct producer sale gas is itself a potential major issue. For reasons discussed earlier, it appears that it should be a fully allocated cost rate at least where the direct producer sale is an alternative to a sale from the transporting pipeline's system supply. See *supra* text at note 175.

<sup>179</sup> It appears that producers are generally selling their gas directly only under short-term contracts because they anticipate higher prices in the relatively near future. They therefore have generally been unwilling, at least up to now, to commit their gas for a longer term at the lower prices that they can now obtain.

<sup>180</sup> The downward pressure is reflected principally in the short-term contract prices, as published in *Natural Gas Intelligence*. See *supra* notes 177 and 179.

<sup>181</sup> A market-out clause gives a pipeline the right to refuse to purchase a producer's gas at the prevailing contract price if that price would make the gas unmarketable. Typically, the pipeline proposes a lower price, which becomes the new contract price if the producer accepts it. If the producer rejects the proposed price, the pipeline is freed of its obligation to purchase the producer's gas and the producer is free to sell the gas elsewhere.

<sup>182</sup> See Energy Information Administration, *Natural Gas Producer/Purchaser Contracts and Their Potential Impacts on the Natural Gas Market* 19, 29 (1982).

gas, and the wide difference between deliverability and takes under existing contracts will narrow. A closer balance between gas supply and demand will reduce downward pressure on the price in new contracts. At the same time, existing producer-pipeline price clauses will be replaced by ones more responsive to market conditions.

## *2. The future role of direct producer sales*

The continued importance of direct producer sales depends on their finding an economic role in a market in which a large surplus and rigid producer-pipeline contracts no longer give them an artificial price advantage. There appear to be three general alternatives for that role. One is to offer service roughly comparable to that of a pipeline, so that a customer potentially could rely on direct producer sales for most or all of his supply. A second is to serve as a supplemental source for customers who continue to rely on pipelines for most of their supply. These two alternatives both depend on the ability of producers to offer a combination of price and service that is, on balance, competitive with that offered by pipelines. The distinction between the two stems from the role that pipelines now perform in balancing gas supply and demand. The first alternative assumes that this role can be played by direct producer sales as well. The second alternative assumes that it cannot. The first alternative is potentially important but probably requires a substantial change in the way that such sales generally are made. The second alternative would require little in the way of institutional change but might relegate direct producer sales to a place of limited and occasional importance in the natural gas industry.

There is also a third alternative: to serve boiler fuel users who are able to shift readily between natural gas and some alternative fuel. This market is potentially highly volatile; large volumes can shift between natural gas and alternative fuels in a matter of hours if gas loses its price advantage. Whether this market can be retained over the long term by gas sales from pipeline and distributor system supply is still unclear. Regulation and average cost pricing may make it difficult for system-supply sales to match short-term changes in alternative fuel prices. Direct producer sales may provide a more flexible means of competing with unregulated alternative fuels.

### *a. The balancing of gas supply and demand*

Consider a natural gas producer in Texas and a potential industrial customer in Illinois. Price, we will suppose, is not a problem. The producer would prefer a high price and the industrial firm a low one, but there exists some range of prices that would make a sale attractive to both parties.

Two problems remain. One is that the gas is in Texas. For it to be useful, it must be transported northwards a distance of a thousand miles or so. The second problem is that the producer's ability to supply gas is unlikely to match the industrial firm's need. Even if the two amounts were equal on average over, say, the next year, they are unlikely to be even roughly equal at particular points during the year. The producer generally can supply gas at a steady rate, subject to occasional (and often unpredictable) interruptions due to well freeze-ups and other causes. The industrial customer's demand will vary perhaps with the weather and certainly with the economy; it may even vary widely over a single day if the plant is not operating around the clock. Additional sources of divergence between potential supply and actual need are likely to emerge over the longer term. Production from existing wells will decline. The producer can drill additional wells, but with uncertain results; the new deliverability may be either more or less than the original one. The customer's

need for gas may change as a result of economic growth or decline or technological change.

For the transportation of the gas from Texas to Illinois there is no practical alternative to a pipeline. One can, on the other hand, imagine a number of ways of balancing the producer's gas supply with the industrial customer's demand. In theory, the balance might be maintained solely through the market. In practice, most of this responsibility also has been taken by pipelines.

*(i.) Pipelines' role in balancing gas supply and demand*

Pipelines' role in balancing supply and demand can be divided into three parts: elimination of random fluctuations in supply and demand; moderation of non-random fluctuations caused by weather and the business cycle; and assurance of a balance some years into the future. Pipelines' ability to perform each part of the balancing role rests on specific physical and institutional factors.

Pipelines are able to eliminate random fluctuations in supply and demand through diversification of supply sources and markets. Pipelines purchase gas from a large number of producers, and from an even larger number of wells, and they sell it to a number of customers. The numbers at both ends are large enough that purely random variations in supply and demand generally are lost in the total. In this respect, pipelines offer producers and consumers the same advantage that a diversified mutual fund offers investors.

But not all supply and demand fluctuations are random. Summer and winter come to all parts of the nation at the same time, and within those seasons exceptionally warm or cold weather may strike a pipeline's entire service area. Economic recession and recovery generally are similarly widespread in their impact.

Pipelines deal with non-random fluctuations in two ways. One is through contracts. In the field market, the difference between deliverability and the take-or-pay level allows pipelines to vary takes without contractual penalty; interruptible contracts give them or their distributor customers a similar flexibility in their sales markets. The second way is through storage. Pipelines can vary the amount of gas contained in the pipeline itself (line pack) through controlling line pressure, and larger amounts of gas can be put into conventional storage facilities.

The assurance of a longer term balance between supply and demand has rested on contracts. Pipelines acquire gas under long-term contracts of up to 20 years, and sell most of it to distribution companies under service contracts typically running 10 years.

These means can to some extent be substituted for one another. For example, a larger industrial load may be a substitute (though an imperfect one) for more storage. In some combination, however, they have been essential to the balancing role now performed by pipelines. Without them either the supply of gas to consumers would have been less certain and flexible, or purchases from producers would have been more erratic. In the first case, the value of the product would have been less; in the second, either its price would have been higher or its supply would have been smaller.

Let us return now to the hypothetical sale by the Texas producer to the Illinois industrial firm. For the producer, the alternative to the direct sale is a sale to a pipeline; for the industrial firm it is a purchase from pipeline system supply. If the balancing role can be performed as well through the direct sale as through the pipeline, the two parties will be willing to deal directly with each other if the price terms at least match those available from the pipeline: if the price to the producer is at least as high and the cost to the industrial firm is at least as low. But if the balancing role cannot be performed through the direct sale, then at least one of the two parties

will have to accept a less satisfactory product. Average takes from the producer will be lower, deliveries to the customer will be more erratic, or both.

There is a market for less satisfactory products, but not at the same price commanded by superior ones. The producer would be willing to sell his gas despite lower average takes if the price were higher. The industrial firm might find the producer's gas a satisfactory bargain despite erratic deliveries if its cost were low enough. If direct producer sales cannot perform the balancing role, then it is not enough for those sales merely to match the price terms available from a pipeline. Direct producer sales may offer nonprice advantages. They may offer end-users greater assurances against curtailments if supply shortages like those of the 1970's recur. Even if no shortage is anticipated, in some markets the greater flexibility of direct producer sales may offset their inability to balance supply and demand as effectively as pipeline sales; this possibility will be discussed in the next section. Otherwise, they must offer measurably better price terms to the producer, to the customer, or to both.

*(ii.) Direct producer sales and the balancing of gas supply and demand*

Can the balance be maintained through direct producer sales? If it can, such sales can constitute a full alternative to sales from pipeline system supply. If it cannot, they generally can serve only as a supplemental source of supply.

The question cannot be answered even tentatively in the abstract. It is necessary first to add some flesh to the barebones definition of direct producer sales that has served up to this point. That definition has been essentially negative: A direct producer sale is one in which no pipeline buys and resells the gas before it reaches the consumer.

The definition is not arbitrary. Pipelines' balancing role is closely linked to their role as gas marketers. But the definition is consistent with a number of very different kinds of transactions. One, the simplest, consists of sales made directly by producers to end users. A broker frequently is involved in these sales, but the broker's role is limited to bringing the parties into contact and helping them negotiate the sale. The broker plays no role in the subsequent administration of the contract. He may participate in the negotiation of a number of direct sales, involving different producers and customers, but each is a separate transaction unrelated to the others; the broker does not aggregate supply from several sources to serve several customers.

A second kind of direct producer sale involves an intermediary that plays a more active and continuing role than a broker. To play such a role, the intermediary in practice is likely to take title to the gas, purchasing it from the producer and reselling it to an end user or distributor. Such an intermediary will be called an independent marketer, to distinguish it from intermediaries that limit themselves to a broker's interest in the transaction. Because the independent marketer is itself a party to contracts with the producer and customer, it must bear some responsibility for the day-to-day administration of those contracts. And because it takes title to the gas, it may be in a position to treat gas purchased from different producers as a common pool from which sales can be made to several customers. At the limit, an independent marketer may in essence be a pipeline without pipe, performing all the functions of a pipeline company except transporting the gas.

A third kind of direct producer sale is one to a distribution company. The significance of the distinction between sales to end users and sales to distributors depends on the size and sophistication of the latter. A sale to a small distributor may be little different than a sale to a single industrial end user. And if the distributor serves primarily residential and commercial customers, the balancing problems may



be more serious than those posed by direct industrial sales. At the other extreme, a sale to a very large distribution company like Southern California Gas may be functionally little different than a sale to a pipeline. Southern California acquires gas from a number of different sources, operates its own storage facilities, and has annual sales substantially larger than those of any of its pipeline suppliers. A direct producer sale to a distributor of this kind legally bypasses the pipeline, but the distributor may be as capable of performing the balancing role as a major pipeline.

Finally, a fourth category consists of sales in which the broker's or independent marketer's role is performed by a pipeline or pipeline affiliate. This alternative is most visibly represented by the industrial sales and contract carriage programs approved by the Commission;<sup>183</sup> but some intrastate pipelines have taken a similar role, and so apparently have interstate pipelines outside the context of Commission-approved programs.

This list is not exhaustive. Producers might create marketing affiliates that would buy from independent producers as well as their own parent; large distributors might follow an analogous policy. The alternatives listed above will, however, suffice to suggest the range of possibilities.

Some means of balancing supply and demand may serve equally well for all forms of direct producer sales, and as well for direct producer sales as for sales from pipeline system supply. Market prices and long-term contracts may adequately maintain a long-run balance between supply and demand. Indeed, market prices may do so alone. Long-term contracts therefore may be of less practical significance in the future than they have been in the past. Long-term contracts have mattered in the past for two reasons. They have established a price that generally has been different than the one being paid for new supplies. Until recently, the long-term contract price generally was lower; today for some pipelines it is higher. They also have helped to assure that supplies would be available when new reserves could not be acquired at virtually any price.

But the price terms of new long-term contracts are likely to maintain the contract price near the competitive market level. And with the substantial partial deregulation of gas scheduled to occur in 1985, supply should be available to any purchaser willing to pay the price. Under those conditions, the practical difference between acquiring gas under long-term contracts and acquiring it through a series of shorter-term ones may no longer be great.

If long-term contracts with distributors or end users are required, however, they can be signed as easily by producers as by pipelines. Direct producer sales are now closely associated with the spot or short-term contract market, but the two concepts are distinct. Producers have made long-term direct sales to end users in the intrastate market.<sup>184</sup> The current dominance of short-term contracts in direct producer sales stems more from producers' unwillingness to commit their gas for a long term at prevailing low prices than from any intrinsic difficulty in negotiating long-term direct producer sales. Possibly a spot market requires direct producer sales; pipelines may be unwilling to buy or sell gas under short-term contracts. But direct producer sales do not require a spot market. Producers can sell gas under short-term contracts or long-term ones. If long-term contracts will make gas more valuable and marketable, producers as well as pipelines can sign contracts for the long term.

The principal problem for direct producer sales lies in maintaining the short-run balance between supply and demand. An assured long-term supply does

<sup>183</sup>See *supra* text at note 117.

<sup>184</sup>See Intrastate and Interstate Supply Markets, *supra* note 2, at 10.

not solve this problem. Nor, probably, is it practical to rely on price, at least as the solution to very short-term supply and demand fluctuations. The means used by pipelines for dealing with short-term fluctuations were noted earlier: contractual flexibility, storage, and diversity of supply sources and customers. The first of these is available to producers. Producers can accept takes that fall short of deliverability when they sell directly, just as they do when they sell to a pipeline, and they are free to sell gas on an interruptible basis. However, contractual flexibility makes the sale less valuable. A lower average take reduces its value to the producer, and at the other end interruptible service is worth less than firm service. If producers rely solely on contractual flexibility, they will place themselves at a competitive disadvantage in relation to pipelines.

Pipelines limit their reliance on contractual flexibility by also using storage and diversity to maintain a balance between short-run supply and demand. Storage may in some cases also be available for direct producer sales. Pipelines sometimes offer storage as a separate service. If the pipeline also allocates all storage costs to the customers responsible for them, and the implicit storage rate included in the sales price to those customers equals its rate for the separate storage service, then direct producer sales and sales from pipeline system supply should stand on an equal competitive footing in this respect. The direct producer seller can offer the advantage of storage at the same price as the pipeline, or it can sell gas without storage but at a lower price.

Pipelines are, however, under no obligation to offer a separate storage service, and most storage is controlled by pipelines. The remaining storage is controlled principally by distribution companies. To offer a gas service based on storage, a direct producer seller therefore probably is dependent on the cooperation of a pipeline or distributor. That cooperation presumably is assured if the sale is arranged by a pipeline or pipeline affiliate or is made to a distributor. For other direct producer sales, on the other hand, the availability of conventional storage presumably would depend on the perceived self-interest of the pipeline or distributor.

The same conclusion appears to apply to the use of line pack as storage. A pipeline or distributor can absorb some short-term fluctuations in supply and demand simply by varying the amount of gas contained in the system. Through increased compression the amount can be increased; similarly, for a short period a pipeline or distributor can supply more gas than it receives by allowing line pressure to fall. Operational and safety concerns limit the range of pressures that can be allowed, but within that range changes in line pack are an important means of maintaining a short-term balance between supply and demand.

In principle, a pipeline could offer other sellers the advantage of this flexibility. The pipeline could use variations in its own line pack to "lend" gas to the other seller during peak periods and accept repayment during slack ones. No interstate pipeline, so far as we know, in fact offers such a service. Possibly one could be created; the rate presumably would be based on the additional compression costs required to increase line pack. Even if such a service were created, however, its practical availability, like that of storage, would depend on the cooperation of a pipeline or large distributor.

From the standpoint of the direct producer seller, the problem with pipelines' diversity of supply sources and customers is that the diversity is essentially costless. What it principally requires is size, and the only costs involved are the bureaucratic costs of a large organization. For this reason, pipeline sales from system supply generally have an inherent advantage over direct producer sales between a single producer and a single end-user customer. Even if storage can be arranged, the service offered in a direct producer sale of this kind is likely to be inferior to that

offered by a pipeline. Both the producer and the customer will be exposed to the risk of random fluctuations that are eliminated or at least reduced by a pipeline's pooling of gas from many sources for sale to numerous customers.

This disadvantage could be offset through price; that apparently is, indeed, the economic basis for the simple direct producer sales now being made. The producer can be offered a higher price and the customer a lower one. However, such price concessions narrow the margin between the price paid to the producer and the price paid by the customer. Out of this margin the costs of transportation must be paid, and the broker or independent marketer (if any) must take its profit. Seemingly, in a world of reasonable supply-demand balance and flexible producer-pipeline contracts, simple direct producer sales generally can compete with pipeline sales only if the cost of transporting direct sale gas is appreciably lower. This seems unlikely. It also seems undesirable: In a rational gas market, the cost of transporting gas should not depend on the legal form of the transaction.

The only direct producer sales that are likely to be able to compete generally with pipeline sales without the artificial advantage created by the large surplus and rigid producer-pipeline contract are ones that also are based on a diversity of supply and customers. Independent marketers can achieve that diversity if they are large enough. Large distributors can achieve it by purchasing gas from a number of sources. Pipelines themselves can also aggregate sources and customers for direct producer sales if they choose to offer such a service as an alternative to their own system supply sales. But the simple sale by producer to end-user in general cannot.

The need for transportation, storage, and diversity together define the long-term commercial possibilities for direct producer sales as an important part of the natural gas industry. For independent marketers the essential requirements are access to transportation and storage and sufficient size to offer diversification. Legislation may guarantee access to transportation and perhaps even to storage. Legislation cannot make an uneconomically small enterprise economical. On the other hand, a viable independent marketer probably need not match the size of a major pipeline. The investment portfolio analogy suggests that there is a point of diminishing returns in the diversification benefits of increased size.

A large distributor may well have its own storage and probably is large enough to provide the necessary diversity without assistance from a pipeline. Its principal need is transportation.

The potential future role of direct producer sales in which a pipeline takes the role of broker or a pipeline affiliate actually buys and sells the gas raises a question of a different sort. Access to transportation and storage presumably is not a problem, nor probably is size. The question is: why would a pipeline wish to offer such a service? Pipelines' present use of direct producer sales through their industrial sales and contract carriage programs is closely linked to the surplus and the rigidity of their producer contracts. Those programs will, like other forms of direct producer sales, have to find a different basis in the future if they are to continue. Other forms of direct producer sales may find an adequate role simply in providing competition for pipelines. An independent marketer may prosper by being able to offer better terms than some pipelines for some substantial number of sales. A distributor may wish to acquire a substantial part of its supply through direct producer sales in order to provide a check on its pipeline supplier. A competitive role of this kind is, however, unlikely to commend itself to the pipelines themselves. Pipelines may, on the other hand, continue to find direct producer sales a useful or even a necessary means of competing with unregulated alternative fuels.

*b. Direct producer sales and competition with alternative fuels*

Over the long run, the price of natural gas is likely to be determined by competition for boiler fuel customers capable of using both gas and an alternative fuel. Such customers can be quickly lost if gas loses its price advantage. It may lose that advantage if gas prices rise without regard to market conditions, as they did in the recent past. But it may also lose its price advantage if gas prices simply fail to change quickly enough to match changes in the price of the unregulated alternative fuel. The problem for the natural gas industry is not just to maintain gas prices at a level that is reasonable over the long-term, but also to devise mechanisms that will allow short-term price flexibility.

The required flexibility is now achieved principally through changes in the distribution margin. Most states allow certain retail gas rates to vary with the price of the competitive alternative fuel, so long as the gas price does not fall below the distributor's variable cost. The difference between the price and variable cost is the unit contribution to fixed costs by the customers who buy gas at the flexible price; that contribution necessarily varies with the price of the alternative fuels.

Similar rate designs have been proposed to the Commission by several interstate pipelines, but the Commission has shown little enthusiasm for them. Arguably the best place to achieve most of the needed price flexibility, however, is not in either the distributor or pipeline margin but in the price received by producers for their gas. Unlike distributors and pipelines, producers are unregulated. Because they are free to profit when alternative fuel prices rise, they can reasonably be expected to bear the burden when those prices fall.

Producer price flexibility could be achieved through the general contracts under which they sell gas to pipelines. Some form of net-back price clause with monthly redeterminations presumably would serve the purpose. This form of price flexibility has implications that may not be acceptable, however. It implies that the gas costs for *all* customers — and not just industrial and utility customers capable of using alternative fuels — would change immediately and directly with the price of an unregulated alternative fuel. Gas costs to residential and commercial customers

would not necessarily be higher on average, but they would be significantly more volatile.<sup>185</sup>

The price of gas to boiler fuel users must be volatile if gas is to compete with its unregulated competitors. For residential customers a more stable price may be preferred; such customers cannot expect to buy gas at a price that is below the long-term market level, but they may prefer that their price not track the short-term changes of prices of fuels that are for them no alternative at all. The two goals do not conflict, provided the cost of gas to price-sensitive industrial users is decoupled from its cost to other users. In principle this could be done entirely through sales from system supply. Pipelines could acquire part of their gas for industrial customers under the kind of flexible contract described above and the balance of their supply under contracts that provided only for an annual price redetermination. The price of gas to industrial users would be determined by the pipeline's gas costs under the first kind of contract; the price to other users would be determined by its gas costs under the second kind of contract.

Over the long term, the average price under the two kinds of contracts should be roughly the same, but at any given time they could be significantly different, and thus so could the gas prices paid by the two classes of customers. Those price differences would not stem simply from different fixed-cost margins for the two kinds of sale. The differences would reflect differences in the cost of the gas itself.

There does not appear to be anything administratively impractical about this form of dual-price system. It may, however, raise legal and political problems, particularly if the price under a pipeline's flexible contracts were to remain below the price under its other contracts for an extended period. These potential difficulties suggest that pipelines might prefer to limit sales from system supply to customers who value — or at least do not object to — more stable gas prices. Other customers would not be abandoned, but they would be served by direct producer sales arranged by the pipeline or an affiliate.

The mechanism just described closely resembles the industrial sales and contract carriage programs that some pipelines have already established. Those

<sup>185</sup> Suppose that 20 percent of the sales of a distribution company are made to price-sensitive customers who could quickly switch to an alternative fuel, and that the price of gas to those customers is just low enough to prevent them from switching. If the price of the alternative fuel falls 10 percent, the price of gas to those customers must also be reduced by 10 percent in order to avoid fuel switching. There are two ways that this can be done if all customers are served on the basis of the same average cost of gas. First, the distribution and/or transmission margin for the price-sensitive customers might be reduced enough to lower the total gas cost to them by 10 percent. Since sales to other customers are four times as large as sales to the price sensitive customers, the resulting reallocation of fixed costs would increase total gas costs to the other customers by one fourth of 10 percent, or 2½ percent. Second, the pipeline's gas supply might be purchased under net-back contracts that provided for short-term adjustments in the price of gas. The fall in the price of the alternative fuel then would result in a 10 percent reduction in the cost of gas for all customers. Conversely, if the price of the alternative fuel increased by 10 percent, the two alternatives would lead, respectively, to a 2½ percent decrease in gas costs and a 10 percent increase in gas costs to other customers.

As this example illustrates, these alternatives differ in two respects. The first relates to the magnitude of the price changes. So long as the price-sensitive load accounts for less than half of total sales, the cost of gas to other customers will change less if the marketability to the price-sensitive customers is maintained by adjusting distribution margins than if it is maintained through short-term changes in the average cost of system supply gas. The second difference relates to the direction of the price changes. If the marketability of gas is maintained through adjusting distribution margins, a fall in the price of alternative fuels increases the cost of gas to nonprice-sensitive customers. If it is maintained through adjusting average gas costs, a fall in the price of alternative fuels decreases the cost of gas to those customers.

It should be noted that these differences refer to the short-term effects of changes in the price of alternative fuels. Over the longer term, average gas costs presumably will tend to follow alternative fuel prices even if gas supply contracts do not provide for short-term net-back adjustments.

programs are generally viewed as a temporary response to the gas surplus and the inflexibility of existing producer-pipeline contracts. Similar programs may, however, be a useful means of reconciling conflicting goals in marketing a product that is at once a commodity involved in close price competition with unregulated fuels and a public utility service depended on by millions of households that lack any short-term alternative.