THE IMPACT ON GAS DISTRIBUTION COMPANIES OF FEDERALLY APPROVED SPECIAL MARKETING PROGRAMS

*J. Richard Tiano**
*Richard P. Bonnifield***

I. INTRODUCTION

Phased decontrol of wellhead natural gas prices under the Natural Gas Policy Act of 1978,[1] designed to encourage increased production of natural gas, combined forces with the "energy crisis" of the early 1970's to raise new problems for the natural gas industry. The interstate pipeline industry, still shocked by the "gas shortage" and curtailments of the early 1970's, engaged in an aggressive gas acquisition program to assure long-term supplies to meet their present and future market requirements. Purchase gas contracts executed during the late 1970's and early 1980's reflected the perceptions that oil prices would continue to rise and that demand for natural gas would remain fairly constant notwithstanding national conservation efforts. The contracts were long-term, relatively inflexible and arguably one-sided.[2]

As gas prices rose in the 1980's, however, oil prices declined. Marginal markets — mainly the high-volume industrial sector — found it economic either to install more fuel efficient equipment, to use No. 6 fuel oil where dual-fuel burning equipment was in place, or to convert permanently to an alternative fuel, principally coal. Consumption of natural gas dropped precipitously, and the interstate pipelines were left with an oversupply of committed, high-priced natural gas. Gas distribution companies likewise experienced load loss and, concomitantly, the cost of natural gas became a larger portion of their "cost of doing business."

In an effort to deal with these changed conditions in the natural gas industry, the Federal Energy Regulatory Commission (FERC or Commission) has responded with several different approaches to enhance the marketability of natural gas. While the Commission's forward-looking efforts are to be congratulated, the Commission must temper its desire to increase sales and gas-for-gas competition by a greater sensitivity to the distinct obligations of local distribution companies and the needs of their customers. Not since the curtailment era of the 1970's has the Commission's conduct so vitally affected the future of distribution companies and their customers. Yet, the Commission seems to have overlooked the secondary impact which its action at the pipeline/producer level portends at the distributor/consumer level.

This article examines many of the areas in which the Commission has acted to alleviate the marketing difficulties of pipelines. Special attention is given to the

*Partner, Wickwire, Gavin & Gibbs, P.C., Washington, D.C.; B.A. *cum laude* Georgetown University; J.D. Georgetown University Law Center; Member of the District of Columbia and Virginia Bars; Adjunct Professor, Georgetown University Law Center.

**Associate, Wickwire, Gavin & Gibbs, P.C., Washington, D.C.; B.A. Washington & Lee University; J.D. Gonzaga University School of Law; M.B.A. Gonzaga University; Former Special Assistant to the Acting Deputy General Counsel for Litigation and Enforcement, Federal Energy Regulatory Commission.

[1] 15 U.S.C. §§ 3301, *et seq.*

[2] Energy Information Administration, "Competition and Other Current Issues in the Natural Gas Market," DOE at 11 (1984).

distinct concerns of distributors as they cope with new special marketing programs and the advent of gas-for-gas competition. While the authors appreciate distributors' desires to retain industrial loads, it is submitted that distributors should concentrate their energies on sensible schemes designed to reduce pipeline gas costs "across the board" rather than exclusively to marginal markets. Likewise, the Commission must take a longer view of the public interest since programs designed to address short-term excess deliverability of supply may cause long-term detriments to the consuming public.

Off-System Sales

The first effort of the interstate pipelines to remedy on-system oversupply of natural gas was the off-system sale. Off-system sales are short-term, interruptible sales made outside the traditional market area of the pipeline.[3] Originally conceived as a means of reducing pipeline take-or-pay exposure under gas purchase contracts with independent producers while permitting the pipeline to continue contracting for long-term reserves,[4] the off-system sales program fell far short of reaching its designated goal for most pipelines. Off-system sales did, however, help to close the gap between the relatively low priced on-system supply of the interstate pipeline and the higher priced supply in the intrastate pipeline gas market.

The Commission authorized off-system sales where the volumes were priced at the higher of the pipeline's on-system average load factor rate (100% load factor rate) or its average NGPA Section 102 gas acquisition cost.[5] This price floor was imposed to assure that the pipeline's on-system distribution company customers would not be harmed by the off-system sale. Because of a substantial variation in the weighted average cost of gas to various interstate pipelines, the "100% load factor rate" requirement, however, all but eliminated those interstate pipelines which had contracts for high cost gas.[6]

One of the pipelines which remains especially active in the off-system sales business is Natural Gas Pipeline Company of America (Natural). Over the opposition of several of its distribution company customers.[7] Natural recently persuaded a Presiding Administrative Law Judge that the 100% load factor rate should not be the floor below which an off-system sale cannot be made.[8] The Commission guardedly affirmed thus decision.[9] The distribution company

---

[3]While interstate pipelines did make occasional off-system sales in the past, especially during the 1970's to assist in alleviating the impact of curtailments on the buyer's system, there was little need for such sales during the era of the dramatic expansion of the interstate pipeline industry following World War II.

[4]Off-System Sales Statement of Policy, 23 FERC ¶ 61,140 at 61,305 (1983). As a policy statement, the Commission was not required to apply the statement to all future cases. Pacific Gas and Electric Co. v. FPC, 506 F.2d 33 (D.C. Cir. 1974).

[5]23 FERC at p. 61,307; 18 C.F.R. § 157.210(a)(4); *see, e.g.,* Natural Gas Pipeline Company of America, 19 FERC ¶ 61,273 (1982); Carnegie Natural Gas Co., 23 FERC ¶ 61,394 (1983).

[6]Off-System Sales Statement of Policy, 23 FERC ¶ 61,140 at 61,306-307.

[7]Unlike some other interstate pipelines, Natural had not imposed deep curtailments on its customers during the 1970's and had little reason to replenish its depleted reserves with higher cost gas.

[8]Natural Gas Pipeline Company of America, 26 FERC ¶ 63,042 (1984).

[9]Natural Gas Pipeline Company of America, 27 FERC ¶ 61,235 (1984), *reh. denied,* July 30, 1984.

opponents of the off-system sale were concerned about the future rate impact of selling less expensive gas supplies to off-system buyers only to find their rates increased when Natural replaced depleted reserves with more expensive supplies. While the Commission was apparently satisfied that the off-system sale would not be detrimental to Natural's customers, it appeared that FERC's concerns with short-term excess deliverability and reduction of take-or-pay liability were of more paramount importance than future rate impacts. Whether the Commission will ultimately be proved correct remains to be seen.

The introduction of interstate pipeline gas into the non-traditional markets naturally spawned opposition from both intrastate pipelines[10] and customers of the interstate pipeline. Intrastate pipelines complained that the proposed off-system sales put their sales at risk solely because the interstate gas had been subjected to stringent federal price controls unlike intrastate gas. The Commission in its Statement of Policy on off-system sales was receptive to this "market raiding" concern, stating that "it appears only to solve the problems in the interstate market by creating or exacerbating a problem in the intrastate market."[11] Traditional customers of the interstate pipeline, on the other hand, were disturbed that the lower cost gas cushion of their interstate supplier would be siphoned off and sold to the off-system markets.[12]

Texas Gas Transmission Corporation (Texas Gas) recently obtained authority to make off-system sales to certain industrial customers in Cincinnati, Ohio over the strenuous protests of Columbia Gas Transmission Corporation (Columbia).[13] Columbia charged that Texas Gas' off-system sales are a form of "market raiding," and the Commission responded by specifically conditioning certification of the off-system sales so that the sales be limited to consumers which would otherwise use fuel oil.[14] The rationale for this approach appears to be that Columbia would have lost the load to an alternate fuel because its price was too high as compared to fuel oil. The clear implication is that, if Columbia bargained harder to reduce the wellhead price of gas, these loads would remain dependent upon the Columbia system. Stated differently, competition will foster discipline in field markets. While distributor customers of Columbia may ultimately benefit because Columbia's purchased gas costs will be lower, it is too soon to evaluate whether theory becomes reality.

Although off-system sales have been around much longer than some of the other "innovative" marketing programs, they are seen by some as holding out more promise for pipelines and gas purchasers because they address oversupply without being subjected to the Commission-imposed restrictions which have been attached to the special marketing programs.[15] Still others suggest that off-system sales are

---

[10]By and large intrastate pipelines were concerned about the retention of their large industrial loads. This market had been quite lucrative as industry shifted to gas producing states to avoid the ravages of curtailment by interstate pipelines during the 1970's.

[11]Off-System Sales Statement of Policy, 23 FERC ¶ 61,140 at 61,306-307.

[12]*Id.*

[13]Texas Gas Transmission Corp., 27 FERC ¶ 61,034 (1984).

[14]*Id.*

[15]Nowak and Leitch, *New Natural Gas Purchasing Opportunities Emerging,* LEGAL TIMES 23 (March 19, 1984).

only effective for dealing with a regional surplus of gas supply.[16]

Off-system sales do little to improve the market-responsiveness of the interstate pipeline's rates. Their main purpose is to remedy an on-system over-supply of natural gas. While off-system sales can work to lessen take-or-pay liabilities, if the pipeline's mix of system supplies includes a low cost "cushion" of pre-NGPA gas, off-system sales could simply work to accelerate the replacement of such lower cost dedicated supply with higher cost post-NGPA gas. Arguably, pipelines should "husband" these lower cost system supplies for the benefit of their on-system distribution customers who contributed to their original acquisition and to the continuing viability of the pipeline.[17]

As long as the Commission continues to subject off-system sales to the same basic test it applies to on-system sales — that the minimum price for such sales equal the "100% load factor rate" — on-system distributors need not be concerned that an off-system purchaser and their interstate pipeline supplier are profiting at their expense. Distributors must be vigilant to the adverse consequences of off-system sales, especially if the supply on their pipeline supplier is replaced by higher cost reserves.

Minimum Commodity Bills

One of the most controversial impediments to competition in the natural gas market is the minimum commodity bill. The minimum commodity bill is a provision in a service agreement or tariff which requires a distributor to pay for some portion of its contracted quantity of natural gas even if gas is not actually taken. Although these provisions are fairly common in pipeline tariffs, and have been in existence for several decades, they are presently perceived as an obstacle to the transmission of market signals from the consumer market to the pipeline and ultimately to the producers.[18] To the distributor, minimum commodity bills may well be the single largest contractual limitation upon its ability to "swing" from one pipeline to another. The minimum commodity bill may also preclude distributor participation in the self-help transportation alternative available to its end-user customers.[19]

Minimum bills in pipeline tariffs have been challenged on several fronts.[20] In one of the earliest recent cases, *Michigan* v. *Trunkline Gas Co.*,[21] the Commission

---

[16]Sigmon, *Natural Gas Pricing: Is New Legislation Needed?*, 112 PUB. UTIL. FORT. 26, 28 (No. 6, Sept. 15, 1983).

[17]*See supra* note 11.

[18]*FERC Statutes and Regulations* ¶ 32,334 at 32,671 (1983).

[19]*See infra* text accompanying notes 56-69.

[20]Challenges to minimum commodity bills are not a recent phenomenon. *E.g.*, Atlantic Seabord Corp. v. FPC, 404 F.2d 1268 (D.C. Cir. 1978). With higher prices resulting from the operation of the NGPA, the challenges have been more pervasive.

[21]20 FERC ¶ 61,100 (1982). There is currently pending before the Commission complaints filed by Consumers Power Company and Michigan Gas Utilities Company challenging Trunkline's minimum commodity bill which was suspended and replaced with an interim minimum bill. Those complaint proceedings — Consumers Power Co. v. Trunkline Gas Co., Docket No. RP84-56-000, and Michigan Gas Utilities Co. v. Trunkline Gas Co., Docket No. RP84-69-000 — are still in their early stages.

instituted a proceeding under Section 5 of the Natural Gas Act[22] to determine if Trunkline Gas Company's minimum bill is "unjust and unreasonable." Since under Section 5 of the Act, any relief granted would be "only prospective" from the date of the Commission's final order, this remedy left much to be desired.[23] The proceeding was ultimately resolved by settlement and Trunkline imposed a non-gas cost minimum commodity bill.[24]

As conditions in the industry worsened, challenges to minimum bills became less orthodox. Columbia, a pipeline which purchases much of its supply from five other interstate pipeline suppliers, asked the Commission for extraordinary relief from its suppliers' minimum commodity bills after it first cut back its purchases from all of its pipeline suppliers and then discontinued payment of its minimum commodity bill obligations.[25] Columbia alleged that depressed economic conditions and declining demand on its system constituted a *force majeure* excusing performance under the minimum bill provisions of its pipeline suppliers' tariffs.[26]

Many of the *Columbia* minimum bill cases settled, and the settlements probably influenced the Commission's thinking in deciding later to modify minimum bills on a generic basis. Most of the Columbia settlements "waived" Columbia's obligation to pay the variable cost portion of the minimum bill leaving only the fixed cost portion of the minimum bill due. In return, Columbia undertook to finance take-or-pay payments incurred by its pipeline supplier to the extent attributable to Columbia's failure to take.

The Commission proposed a generic rule to eliminate variable costs from all minimum commodity bills.[27] Under the proposed rule, all pipeline tariffs on file with the Commission would be deemed inoperative to the extent they provide for recovery of purchase gas costs or other variable costs through a minimum commodity bill. The Commission reasoned that since, by definition, minimum bills are triggered only when gas is not taken, minimum commodity bills which charge for gas costs which are not incurred are unjust and unreasonable.[28]

---

[22] 15 U.S.C. § 717d. While an argument can be made that the *Mobile-Sierra* doctrine precludes the filing of a complaint since a contract governs the legality of a filing, the authors submit that this is a misapplication of the doctrine. Under that doctrine, pipelines gain no rights to change a fixed rate. Because contracts can be abrogated by the Commission if they adversely affect the public interest, FPC v. Sierra Pacific Power Co., 350 U.S. 348 (1956), a complaint procedure seems fair and is expressly provided for in the Natural Gas Act. 15 U.S.C. § 717d.

[23] 20 FERC at 61,221.

[24] Michigan v. Trunkline Gas Co., 24 FERC ¶ 61,013 (1983).

[25] *E.g.*, Columbia Gas Transmission Corp. v. Texas Gas Transmission Corp., Docket No. RP83-4-000; Columbia Gas Transmission Corp. v. Panhandle Eastern Pipe Line Co., Docket No. RP83-5-000; Columbia Gas Transmission Corp. v. Tennessee Gas Pipeline Co., Docket No. RP83-8-000; Columbia Gas Transmission Corp. v. Texas Eastern Transmission Corp., Docket No. RP83-7-000.

[26] This unilateral action by Columbia would appear to be a violation of the "filed rate" doctrine which binds the pipeline to charge and a customer to pay the rate on file with the Commission. Hope Natural Gas Co. v. FPC, 134 F.2d 287, 311 (4th Cir. 1943), *rev'd on other grounds*, 320 U.S. 591 (1944). Because many of the Columbia proceedings were settled, the Commission has not ruled on the issue.

[27] Elimination of Variable Costs From Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, *FERC Statutes and Regulations* ¶ 32,334 (1983).

[28] *Id.* at 32,670.

The Commission in Order No. 380[29] subsequently adopted its proposed rule by amending its regulations to require elimination from interstate pipeline tariffs minimum commodity bills that operate to recover variable costs.[30]

The Commission's rule left ambiguous the extent to which take-or-pay payments by pipelines constitute fixed costs recoverable through minimum commodity bill provisions. In its Notice of the proposed rule, the Commission refers to the "associated carrying cost" of take-or-pay obligations as a type of fixed cost which, when prudently incurred, might be recovered through a minimum commodity bill. As with the *Columbia* settlements referred to above, the Commission seems to be linking the customer's failure to take under its minimum commodity bill and the pipeline's incurrence of take-or-pay obligations.

These take-or-pay liabilities may well have resulted from other causes like reduced takes by all customers — full requirement customers as well as partial requirement customers subject to a minimum commodity bill. In addition to this causality problem, one must question the wisdom of shifting responsibility for financing take-or-pay obligations to distribution companies served by the pipeline. Ratepayer coverage of take-or-pay liabilities may only guarantee that neither pipeline nor producer will be motivated to renegotiate their long-term gas purchase contracts which may be to blame for the present-day gas glut.

Not all distributors should be pleased by the elimination of variable costs from the minimum commodity bills of their pipeline suppliers. The distributor with the ability to "swing" between suppliers is admittedly given greater flexibility to purchase more competitively priced supplies for its customers. Its payment of fixed costs alone may well be tolerable when added to the gas cost savings it enjoys by switching suppliers. To the extent elimination of variable costs from minimum commodity bills invites distributors with the ability to swing ("partial requirements" customers) to discontinue purchasing from the pipeline supplier, distributors without that ability are left exposed to a major shift in costs and in cost responsibility. Stated differently, take-or-pay liability is transformed from a variable cost associated with gas purchases to a fixed obligation or fixed cost to be recovered in the future, primarily from "full requirements" customers.

The distributor without the ability to swing (the "full requirements" customer) is paying a demand charge as its "minimum bill" because dependence upon the pipeline means it must have certain minimum pipeline capacity on peak days. These demand charges are, to a greater degree than ever before, composed of costs which traditionally have been recovered through the commodity component of the pipeline's rates.[31] With the loss of sales to partial requirements customers, full requirements customers will lose what little contribution to fixed costs remains in the commodity component.

---

[29]27 FERC ¶ 61,318 (1984), *reh. denied*, July 30, 1984. On the same day, the Commission affirmed an initial decision wherein the Presiding Administrative Law Judge concluded that Colorado Interstate Gas Company's minimum commodity bill was unjust and unreasonable, thereby eliminating variable costs from the minimum commodity bill. Colorado Interstate Gas Co., 27 FERC ¶ 61,315 (1984).

[30]Variable costs are the cost of purchased gas, compressor fuel gas and line loss or shrinkage gas.

[31]The current trend to "unload" the commodity rate of pipelines to enhance the marketability of gas is discussed in the next section of this Article.

Minimum commodity bills were in many cases key terms of long-standing contractual arrangements between the pipeline and its customer. While the Commission has authority to abrogate contracts,[32] it must recognize that such contracts, for many years accepted by the Commission, may have evoked substantial reliance by the pipeline in continuing purchases of natural gas at designated levels. In addition to the take-or-pay consequences mentioned earlier, pipeline operations and allocation of capacity may well have depended upon these formerly approved contractual arrangements. Order No. 380 does not appear to address these very serious issues.

Even more disturbing is the possibility already being realized on at least one pipeline,[33] that elimination of variable costs from minimum commodity bills may be only a prelude to the final departure of the partial requirements customer from the pipeline's system. Certainly, to the extent costs have been incurred and investments were made for the benefit and on behalf of the departing customer, a multitude of accountability issues arise.

While issues surrounding minimum commodity bills can be narrowly viewed as simply rate questions, such a myopic view is a mistake. The Commission in Order No. 380 left no doubt that its action was in response to concerns in the marketplace caused by increasing prices and loss of load. Although the immediate impact should be to assist partial requirement distributor customers to realize lower rates for its purchased gas, the impact on retaining or regaining industrial loads still remains an open issue. From the viewpoint of a full requirements customer, that distributor receives no benefit in the marketplace *unless* the Commission's assessment that wellhead prices will be lower is correct. To date, producers have not shown much willingness to reduce wellhead prices on a long-term basis. Whether their willingness to do so will be heightened now is likewise problematical. Modification of interstate pipeline rates is the only tool presently available to the Commission to impact such market decisions.

Rate Design and Imputed Volumes

Consistent with its attempt to make gas more marketable, the Commission has also moved to ease the transition to decontrol through pipeline rate design. For almost a decade, the Commission's preferred approach and the norm on many pipelines was the *United*[34] method of cost classification, allocation, and rate design under which 75% of the fixed costs associated with investment in the storage and transmission facilities of the system were collected in the commodity component and the remaining 25% were collected in the demand component of the pipeline's rates.

In 1983, however, the Commission finally rejected the *United* methodology in an order declining to substitute the *United* method for the then-effective *Seabord*[35]

---

[32]*E.g.*, Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

[33]"Application For Order Permitting and Approving Abandonment of Service," filed April 12, 1984, Mississippi River Transmission Corp., Docket No. CP84-348-000.

[34]*See*, United Gas Pipe Line Co., 50 FPC 1348 (1973), *reh. denied*, 51 FPC 1014 (1974), *aff'd sub nom.* Consolidated Gas Supply Corp. v. FPC, 520 F.2d 1176 (D.C. Cir. 1976).

[35]*See*, Atlantic Seaboard Corp., 11 FPC 43 (1952).

method on the Texas Gas system.[36] In the *Texas Gas* case,[37] the Commission de-emphasized the importance of the capacity and supply considerations which underlay much of the controversy regarding the use of the *United* and *Seabord* methodologies and focused more intently upon present-day market considerations:

> We would note that the emphasis which has traditionally been placed on the fixed costs of transmission and storage facilities for purposes of achieving these goals is no longer warranted for the relevant period. In our view, the record before us demonstrates increased emphasis should be placed on the far more significant purchase gas and other costs incurred by pipelines. The relationship between the purchased gas costs and pipeline sales has become critically important and would appear to be the better vehicle for assuring efficient use of natural gas supplies consistent with marginal cost pricing principles and economic theory.[38]

This expression of skepticism echoed earlier suggestions by the Commission that new rate designs should be developed to give pipelines an incentive to minimize purchased gas costs consistent with their obligation to assure long term, low priced gas supplies for their customers.

In *Tennessee Gas Pipeline Co.*,[39] the Commission cited the need for rate structures which did not insulate pipelines from the consequences of their management decisions "while keeping distributor customers and end-users at risk."[40] The Commission suggested that an "imputed load factor" approach similar to that employed by the Civil Aeronautics Board in the 1970's might help to protect pipeline ratepayers from shouldering the cost burden of under-utilization resulting from load loss.[41] An "imputed load factor" approach would hypothesize sales volumes consistent with efficient management of the pipeline and design rates on that basis. By this method, a pipeline would have to achieve a higher than recently experienced sales volume in order to recover its fixed cost of service.

These were encouraging words to the pipeline's customers because they evidenced a willingness on the Commission's part to hold interstate pipelines accountable not only for the purchasing practices which may have caused unmarketable gas prices but also for their failure to take action with producers to reduce gas costs in view of that unmarketability.

Unfortunately from a distributor's perspective[42] the closest the Commission has come to using a rate design which holds an interstate pipeline accountable for load

---

[36]On the same day, the Commission issued companion orders to the same effect for several other pipeline systems. Texas Eastern Transmission Corp., 22 FERC ¶ 61,163 (1983); Cities Service Gas Co., 22 FERC ¶ 61,162 (1983).

[37]Texas Gas Transmission Corp., 22 FERC ¶ 61,164 at 61,274-275 (1983).

[38]*Id.* at 62,277.

[39]21 FERC ¶ 61,004 (1982).

[40]*Id.* at 61,009.

[41]*Id.*

[42]The authors have taken a broader view of distributors. While the adjective "unfortunate" may be debated by high load factor customers, the low load factor customers are disadvantaged by increases in the demand component of their interstate pipeline's rate. Changes in rate design always involve "winners and losers," but if the Commission's alleged objective is to increase sales at the retail level, this goal will be achieved, if and only if, state commissions replicate interstate pipeline rate designs at the local level. This seems unlikely given the diversity of state law and market areas. In any event, the public interest is broader than high load factor customers.

loss was in its adoption of a Modified Fixed Variable methodology which places return and related taxes in the commodity component of the pipeline's rates. In *Natural Gas Pipeline Company of America*,[43] the Commission approved such a modified rate design. The Commission conceded that recovery of return and related taxes through the commodity component is inadequate as a risk allocator, but suggested the following as alternatives to achieving that end: "imputed load factor rates, incentive rate of return mechanisms, moritoria on rate filings and purchased gas cost incentives."[44] Because the Modified Fixed Variable rate design consisted of a two part demand rate, this rate design closely approximates the *United* rate design it purportedly superseded.[45]

Far from improving market conditions, rate designs which are calculated to "unload" the commodity rate to enhance marketability of gas may do more harm than good. In *Columbia Gas Transmission Corp.*,[46] a Presiding Administrative Law Judge likened this effort to a "gerrymandering" of pipeline costs:

> As long as the sellers of gas at the well head are assured that the Commission will indulge in a gerrymandering of pipeline costs to make their commodity marketable, why should they adjust their prices downward to meet the competition from alternative fuels? The MFV proposals provide a boon to both pipeline and producers, under the guise of an attempt to avoid greater unquantifiable costs being shifted to the consumer in the future, by means of the uncanny device of burdening the consumer with some of those costs now. It is a teasing illusion, like a munificent beqeust in a pauper's will. Even Salome's veils could not have been more diaphanous.[47]

In effect, rate designs like the Modified Fixed Variable method, pave the way for subsidization of high load factor customers by low load factor customers. While this may move a greater number of volumes in the short-term, it also forces the smaller customers of the pipeline to underwrite the high gas costs which put those volumes at risk. If an interstate pipeline is truly to be held accountable for its purchasing practices, rate design should hold the pipeline at risk for loss of sales volumes.

Whether rate design can help or hurt, it surely will not suffice, by itself, as a remedial measure in today's market climate. At best, rate design merely passes the problems of the interstate pipelines — problems largely of their own making — on to their distribution company customers to settle among themselves. While this may be a facile solution to a difficult problem, the underlying assumption, as we will discuss below, is wrong. There is an inequality in bargaining power among a pipeline's customers, and the Commission should not be so hasty to remove itself from the controversy.

---

[43]25 FERC ¶ 61,176 (1983).

[44]*Id.* at 61,483 (citing Tennessee Gas Pipeline Co., 21 FERC ¶ 61,004 (1982)).

[45]Because one part of the demand rate was tied to annual entitlements, the nominations of those entitlements have generated controversy. *See,* Natural Gas Pipeline Company of America, 27 FERC ¶ 61,287 (1984), *reh. denied,* July 27, 1984.

[46]25 FERC ¶ 63,015 (1983).

[47]*Id.* at 65,042.

Special Discount Rates

Next to rate design, the pipelines' most favored[48] solution to competition with alternative fuels is the implementation of what has been termed "Special Discount Rates." A special discount rate is a rate based on the reallocation of fixed costs sufficient to induce customers with alternative fuel capability to continue purchasing gas.[49] Like the drive to "unload" the commodity rate in the context of rate design, these rates are justified on the ground that they enhance competition with alternative fuels by shifting fixed costs away from customers with dual or alternative fuel capability and towards those without. Unlike many rate design proposals, however, special discount rates have no cost-based justification but are based instead on market clearing considerations.

Until very recently,[50] the Commision had uniformly declined to certificate service priced at a discount without a hearing, and only permitted temporary certification on the condition that the pipeline's shareholders assume the risk that the proposed discount rate may undercollect costs.[51] In addition to its concern regarding cross-subsidization, the Commission seemed particularly disturbed that these rates may not be in the long-term best interests of the pipeline and its customers because they "convey an unrealistic picture of the market for natural gas and thus fail to encourage the restructuring of contractual relationships between pipelines and producers that must eventually occur."[52]

While the ultimate success of such special discount rates is speculative,[53] such rates are not unprecedented at the state level[54] and have some historical basis at the FERC.[55] Still, as noted by the Commission, special discount rates fall far short of dealing with the current problems facing the natural gas industry. While their availability may only postpone the inevitable reckoning which must occur between

---

[48]Pipelines favor shifts of fixed cost from the commodity component of their rates because it affords them a greater opportunity to earn their allowed return. Stated differently, their risk of doing business is lessened.

[49]*See, e.g.*, Columbia Gas Transmission Corp., 21 FERC ¶ 61,326 (1982); Michigan Wisconsin Pipe Line Co., 21 FERC ¶ 61,063 and ¶ 61,325 (1982); Northern Natural Gas Co., 23 FERC ¶ 61,295 (1983); Northwest Pipeline Corp., 23 FERC ¶ 61,173 (1983). *See also* Consolidated Gas Supply Corp., 27 FERC ¶ 61,123 (1984).

[50]*See* United Gas Pipe Line Co., 27 FERC ¶ 61,349 (1984) (order granting certificate and placing risk of undercollection on pipeline's shareholders), *amended*, 28 FERC ¶ 61,144 (1984).

[51]*Supra* note 49. The imposition of risk on pipeline shareholders proved to be unmanageable for Columbia Gas Transmission Co. and Northwest Pipeline Corp. *But see* Northwest Pipeline Corp., 27 FERC ¶ 61,167 (1984) *and* Columbia Gas Transmission Corp., 28 FERC ¶ 61,089 (1984).

[52]Columbia Gas Transmission Corp., 21 FERC at 61,873; Michigan Wisconsin Pipe Line Co., 21 FERC at 61,870; Northwest Pipeline Corp., 23 FERC at 61,376.

[53]Despite the Commission's ominous warnings of shareholder risk, Michigan Wisconsin and Northern Natural moved forward with hearings on their applications. Indeed, Northern Natural obtained a favorable initial decision from a Presiding Administrative Law Judge in Northern Natural Gas Co., 26 FERC ¶ 63,971 (1984), which was affirmed by the Commission. 27 FERC ¶ 61,299 (1984).

[54]Energy Information Administration, Department of Energy, "Competition and Other Current Issues in the Natural Gas Market" (RNGD 84-2) February, 1984 at pp. 81-88. *See also* Adair and Bloom, *Flexible Pricing and Other Partial Solutions to The Problems Faced by Gas Distributors*, 4 ENERGY L.J. 239, 243 n.19 (1983).

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

pipelines and producers, these rates favor certain distributors, and this discrimination may not be tolerable in the long-run.

Self-Help Transportation

One of the most constructive of the Commission's actions to date to facilitate movement of gas from wellhead to market was the promulgation of new "blanket certificate rules"[56] under which pipelines can now transport, without administrative delay, gas purchased direcly by end-users from a producer, local distribution company or intrastate pipeline.[57]

Previously, in order to move gas purchased directly from a producer by a low priority end-user (*e.g.*, for industrial uses), pipelines were required to file for and obtain a certificate of public convenience and necessity pursuant to Section 7(c) of the Natural Gas Act. This tedious and time-consuming procedure is now replaced for an "experimental period"[58] with self-implementing procedures to permit immediate commencement of qualifying transportation for a term of up to five years for high priority end-users and up to 120 days for all other end-users. For low-priority end-user transportation beyond a 120-day term or transportation otherwise not qualifying for self-implementation, "prior notice and protest" procedures are to be instituted.[59] Under these procedures, if no party protests the proposed arrangement within 45 days of its being noticed by the Commission, the transportation arrangement may proceed.[60] If, however, protests are filed, the parties have 30 days within which to informally resolve their differences. If a settlement is not reached within this 30 day period, the matter is treated as an ordinary certificate filing under Sections 7(c) of the Natural Gas Act, with attendant delay.[61]

In addition to omitting much of the administrative delay previously encountered in implementing end-user transportation, the Commission has offered interstate pipelines the opportunity to charge more than a fully allocated transportation rate for such self-help transportation. Pipeline rates for end-user transportation may either be the pipeline's currently effective transportation rate or a rate based on the methodology used to recover transmission and related storage costs included in one of the pipeline's then-effective sales rate schedule.[62] The pipeline is permitted to retain revenues from such transportation only to the extent that the revenues or volumes attributable to the transportation fall within "representative levels" reflected in its base rate cost of service. Otherwise, it is only permitted to retain one cent per MMBtu (or out-of-pocket costs) and is required to credit the balance back to its customers through its Account No. 191.[63] To encourage

---

[56]Order Nos. 319 and 234-B, *FERC Statutes and Regulations*, ¶ 30,476 and ¶ 30,477 (1983), *reh. denied*, ¶ 30,512 (1983).

[57]18 C.F.R. § 157.209(a)(2) and (e)(1) (1983).

[58]This period extends from August 1983 through June 1985. 18 C.F.R. § 157.209(e)(1) (1983).

[59]18 C.F.R. § 157.209(c)(2) (1983).

[60]18 C.F.R. § 157.205(h)(1) (1983).

[61]18 C.F.R. § 157.205(f) (1983).

[62]18 C.F.R. § 157.209(d)(1)(i) (1983) (referencing 18 C.F.R. § 284.103(c)).

[63]18 C.F.R. § 284.103(d) (1983).

pipeline transportation of end-user owned gas, the Commission also authorized, on an experimental basis until January 31, 1985, the effectuation of an "added incentive charge" (AIC) tariff under which pipelines can charge, collect, and retain up to five cents per MMBtu more than their fully allocated transportation rate.[64]

The availability of self-implementing end-user transportation has acted as a catalyst to spot market purchasing of natural gas. End-users can "shop around" for the best gas buy, then have the gas transported to their facilities. As long as the gas qualifies for transportation under the blanket certificae program, pipelines and/or distributors can team up with producers to transact, without delay, net back pricing schemes targeted at gaining or retaining specific marginal end-users. Further, producers can get into the business of marketing gas for sale directly to end-users which qualify for automatic transportation. While the possibilities are not endless, the machinery is in place for price competition at the wellhead.

Distributors are understandably anxious about the prospect of a market where high-volume, low priority end-users assume control of their own destiny. Foremost among the concerns is that end-users not be permitted to by-pass the facilities of distributors and leave remaining customers to shoulder the costs of the system. The Commission's answer to this concern is that the transaction simply cannot proceed without the willing cooperation of the distributor.[65] A secondary response is that, in any event, distributors will have an opportunity to demonstrate harm when they protest a proposed transaction pursuant to the "notice and protest" procedures described above.

Neither response is sensitive to the issue. First, the distributor should not be exposed to the legal liabilities associated with refusing access to its system. It is no *per se* defense to alleged antitrust violations that allowing access for transportation is likely to displace sales without which distributor's customers will suffer higher rates.[66] Nor should distributors be expected to litigate at the Commission such adverse consequences every time a transaction is proposed.

While direct producer sales and transportation under the blanket certificate rules hold some promise for producers and end-users, they do virtually no good for the pipeline and distributor which undertook for the benefit of the end-user to contract for supplies and built facilities to serve that end-user.

To this, some[67] might say pipelines (and distributors) are getting their just desserts because their rates (and gas costs) are simply too high. Such a response ignores the fact that pipelines and distributors are generally compelled by the regulatory authorities to "roll in" all their gas costs,[68] something direct purchase arrangements avoid. The response also fails to appreciate the special duty owed by

---

[64] 18 C.F.R. § 157.209(f). *See also FERC Statutes and Regulations*, ¶ 30,477 at 30,613-614 (1983).

[65] *See, e.g., FERC Statutes and Regulations*, ¶ 30,477 at 30,606 and ¶ 30,512 at 30,768 (1983); Transcontinental Gas Pipe Line Corp., 26 FERC ¶ 61,029 at 61,056 (1984).

[66] *Compare,* Mahinka and Johnson, *New Antitrust Issues In A Deregulated Environment,* 4 ENERGY L.J. 211 (1983). Mr. Mahinka and Ms. Johnson suggest that nonpredatory denials of access based on legitimate business considerations such as efficiency and profitability are consistent with antitrust policy. Even if true, the distributor may have to litigate an antitrust suit before it obtains an answer.

[67] Means and Angyal, *The Regulation and Future Role of Direct Producer Sales,* 5 ENERGY L.J. 1, 37 (1984).

[68] This approach was judicially confirmed. Battle Creek Gas Co. v. FPC, 281 F.2d 42 (D.C. Cir. 1960).

the Commission to *all* pipeline customers, not just those with the power and ability to abandon the pipeline. The contention also ignores the obligations of distributors.[69] Rather than facilitating the departure of high-load factor customers from the pipeline and distributor systems — where they are no longer contributing to the cost of operating the systems — the Commission should be developing solutions which benefit *all* customers dependent upon the particular interstate pipeline equitably.

Special Marketing Programs

The term "special marketing program" was coined by the Commission to describe a whole panoply of pipeline- and producer-sponsored proposals to market natural gas outside the traditional sale for resale system. Special marketing programs (SMPs) allegedly enable natural gas to compete with alternative fuel by converting the pipeline's role from reseller to broker/transporter. Under most pipeline-sponsored SMPs, the pipeline surrenders its traditional role as the middle-man between the producer and the retail seller or consumer and assumes instead the role of broker (bringing buyer and seller together) and/or transporter (shipping gas from the field to the market).

The first of these programs was sponsored by Transcontinental Gas Pipe Line Corporation (Transco) as part of a rate settlement reached over a year ago.[70] Transco's Industrial Sales Program (ISP) was designed to permit gas sales to price-sensitive customers which would otherwise be lost to alternative fuels. Transco first "cut back" and contractually released gas under its gas purchase contracts that it could not resell without price relief. Acting as an agent or broker for price-sensitive customers, Transco next offered to buy volumes from the "pool" of released gas if the gas was priced low enough, net of transportation costs, to clear the market. Finally, Transco transported the gas from the participating producer to the price-sensitive customer on whose behalf the purchases are made.

Eligibility to participate in Transco's ISP program was restricted to resale customers purchasing gas on behalf of an end-user with alternative fuel capability which, without price relief, would not buy gas. It was thus left to the customers of Transco to arrange with the qualifying end-users for purchase of ISP volumes. Since these customers (mainly distributors) knew which of their traditional customers have been or could be lost to competition with alternative fuels, they were the key to the success of the ISP program.

Within no time, variations on the ISP program proliferated.[71] As the Commission's learning curve rose, so did the number of limitations it imposed as conditions to their authorization. Most of these limitations were aimed at maximizing the benefits of these programs for the on-system customers of the pipeline. For example, the Commission required that no gas released under a program could be sold unless its weighted average cost before release equaled or exceeded the

---

[69]*See infra* text accompanying notes 88-105.

[70]Transcontinental Gas Pipe Line Corp., 23 FERC ¶ 61,199 (1983).

[71]*See, e.g.*, Columbia Gas Transmission Corp., 25 FERC ¶ 61,220 (1983), *amended*, 26 FERC ¶ 61,031 (1984); PanMark Gas Co., 26 FERC ¶ 61,341 (1984); Tenneco Oil Co., 25 FERC ¶ 61,234 (1983), *amended*, 26 FERC ¶ 61,030 (1984).

pipeline's weigh average cost of gas (the "WACOG").[72] This way, gas released and sold under the program should not raise the weighted average cost of the pipeline's sytem supply, thereby disadvangtaging non-participating customers. Another Commission imposed requirement was that producers could only tender volumes to such a program to the extent they waived claims to take-or-pay obligations associated with such volumes.[73] Similarly, volumes sold under the program had to be credited against a distribution company's minimum commodity bill obligations.[74]

The most controversial of the Commission imposed limitations on certification of these programs was the definition of eligible purchasers. As originally conceived, Transco's program was available only to its distributor customers purchasing on behalf of end-users which, without price relief, would not purchase natural gas. The Commission determined later to expand eligibility to "indirect customers," thereby permitting end-users to be purchasers without depending upon their distributors as their agents or brokers.[75] Spurred by the advocacy of large industrial consumers, the Commission ultimately expanded eligibility for purchase of SMP volumes to customers served under interruptible sales rate schedules.[76]

The Commission recognized that by opening up SMPs to include all interruptible loads, it was inviting gas-for-gas competition between pipelines and distributors.[77] As with its rationalization of Order 319 and 234-B,[78] the Commission summarily discounted claims of sales displacement and shifting costs among customers on the ground that distributors can always refuse to transport for end-users and that, in any event, distributors will have an opportunity to prove any adverse impact when a certificate is sought for changing delivery points.[79]

The similarity of this Commission response to that expressed in the self-help transportation context is not surprising since the perceived threats are essentially the same. In both cases, the end-user is armed with all the authority it needs to circumvent the rigors of paying a rolled-in, system-wide price for gas and can spot purchase gas directly from producers or other nontraditional gas suppliers. The pipeline, in turn, is enticed to transport this gas because it improves its load factor, reduces its take-or-pay exposure and — to the extent it is permitted to retain revenues from transportation — enhances stockholders' earnings. At a minimum, the pipeline is made economically indifferent to whether it sells gas for resale or transports gas from others. In any event the pipeline is guaranteed its cost of service and at least the prospect of enhanced return if it exceeds designed transportation volumes. Once the gas is purchased and the pipeline transportation is arranged, the distributor is cast in the unseemly role of the "spoiler" unless it too agrees to transport the volumes.

---

[72]*See, e.g.,* Tennessee Gas Pipeline Co., 25 FERC ¶ 61,398 at 61,889 (1983).

[73]*See* Tenneco Oil Co., 25 FERC ¶ 61,234 at 61,606 (1983); Tennessee Gas Pipeline Co., 25 FERC ¶ 61,398 at 61,889 (1983).

[74]Because demand charges are, in effect, a minimum bill, there should be credits to demand charges. In the several programs authorized by the Commission, there has been no consistent treatment of this issue.

[75]Transcontinental Gas Pipe Line Corp., 25 FERC ¶ 61,219 at 61,558 (1983).

[76]*See, e.g.,* Transcontinental Gas Pipe Line Corp., 26 FERC ¶ 61,029 (1984).

[77]*Id.* at 61,056.

[78]*Supra* text accompanying notes 65-69.

[79]Transcontinental Gas Pipe Line Corp., 26 FERC at 61,056.

If the distributor chooses to contest the arrangement as adverse to the interests of its customers, the prospects of prevailing are tenuous at best. First, there are no clear, objective standards by which to judge this issue. If the analysis is a net benefit test, there can be no doubt that the per Mcf savings to the large industrial end-user will far exceed the shift of fixed costs that would result by loss of the load. If, on a more philosophical level, the choice becomes one of industrial growth versus higher gas rates to captive gas consumers, politics will undoubtedly dictate jobs first, rate relief later.

Moreover, the "right" to a hearing may be no right at all, if the Commission's treatment of objections to the original special marketing proposal is any indication. The Commission in the same group of rehearing orders which so boldly expanded eligibility to all interruptible customers, whether served by an interstate pipeline or a distributor, refused to hold hearings on the theory that conflicting predictions about the impact of the programs do not require a hearing.[80]

The Commission has looked favorably upon SMPs principally because they invite producers to make concessions on price and non-price (*i.e.*, take-or-pay) contract terms in order to sell gas to the pipeline's price-sensitive customers. It should be noted in this context that special marketing programs and blanket certificate transportation programs probably work at cross purposes. The former were welcomed by the Commission because they promised to reduce mounting take-or-pay liabilities of the pipeline[81] at a time when the gas most likely to be subject to take-or-pay simply would not clear the market. An underlying assumption was that producers were in dire need of selling gas to maintain cash flow and production of associated liquids and to pay royalty. With the ready availability of self-implementing transportation, producers are free to sell new, uncommitted gas reserves to any end-user without making any concessions on take-or-pay or on price under existing contracts. To the extent such direct sales are successful, the cash flow impetus to renegotiate rigid, long-term contracts is virtually non-existent. The producer's behavior is not too difficult to understand since, with contract in hand, producers stand a better chance of profiting through the passage of time than by discounting prices or relinquishing take-or-pay rights under special marketing programs.

Distributors — Their Changing Role

As long as the Commission is solicitous of programs that encourage large industrial and commercial consumers to deal directly with gas producers and by-pass their traditional gas supply systems, distributor participation in the process of developing and assessing such programs is particularly crucial. All too often in the recent past the Commission has been more influenced by the industrial sector (with general support from the producing community) than by distribution companies.

---

[80]Columbia Gas Transmission Corp., 26 FERC ¶ 61,031 at 61,081-084 (1984); Tenneco Oil Co., 26 FERC ¶ 61,030 at 61,064-067 (1984). *See also* Tennessee Gas Pipeline Co., 25 FERC ¶ 61,398 at 61,888 (1983).

[81]The take-or-pay relief was described by the Commission as "the fundamental premise" underlying its authorization of special marketing programs. PanMark Gas Co., 26 FERC ¶ 61,341 at 61,746 (1984).

The Commission must be disabused of certain erroneous assumptions about the nature of the gas business and the "benefits" of gas-for-gas competition. The balance of this article will examine some of these assumptions and suggest, from the standpoint of the distributor, constructive alternatives to better serve the interests of the whole public.

Although special marketing programs were originally designed to address the unique problems of the pipeline's distributor customers, they have become something quite different. No longer are they predicated upon tangible benefits to on-system pipeline customers — benefits like retaining load otherwise lost to alternative fuel — but are now heralded as a means of engendering greater competition in the natural gas market in the "hopes that it will lead ultimately, as a result of price competition at the wellhead, to [a] non-discriminatory reduction in all users' gas costs."[82] The theory is that by fostering competition among gas suppliers to save interruptible load ("gas-for-gas competition"), producers will themselves be pitted against each other in competition for natural gas consumers, resulting in lower prices for all consumers.[83]

Reality probably works in the reverse direction. A proliferation of gas buyers in the wellhead marketplace means the emergence of a sellers' market[84] and ultimately higher prices for natural gas consumers.[85] First, additional buyers will "bid up" gas prices, not demand lower prices. Since low-priced gas under Sections 104 and 106 of the NGPA is already under contract, these additional buyers will be competing for new gas supplies (discovered or yet to be found). Second, since it is the direct purchase industrial user which will be swinging the most weight in this new wellhead marketplace, the price which it can pay producers will be increased to the extent it has avoided the costs of its traditional suppliers' (pipeline and distribution) systems. Other potential buyers, like pipelines and distributors, will consequently pay more, not less, to compete effectively.[86] Finally, because the pipeline and distributor will have lost the volumes and the "load balancing" value of interruptible load on their systems, they will simply lack that much more leverage in obtaining a reasonably priced package of gas.

A related rationale for facilitating direct producer purchase arrangements is the notion that such sales improve the "transmission of market signals" from burner tip to wellhead.[87] According to this view, enabling end-users to deal directly with producers will cause producers to react directly to forces in the marketplace instead of being insulated by the rolled-in pricing mechanisms of interstate pipelines and distribution companies. While it may be that direct purchase arrangements inform the producer as to the price the large industrial end-user is willing to pay, it is a signal that does nothing for consumers incapable of entering into such arrangements. In

---

[82]Notice of Inquiry, *Impact of Special Marketing Programs on Natural Gas Companies and Consumers, FERC Statutes and Regulations*, ¶ 35,315 at 35,586 (1984).

[83]*Id. See also* Transcontinental Gas Pipe Line Corp., 26 FERC ¶ 61,029 at 61,053 (1984).

[84]A review of the Commission's Monthly Gas Industry Activity Reports during the last year shows a decline in exploration and development of new gas reserves. This trend is ominous since it portends the likelihood of a new era of curtailments by interstate pipelines.

[85]*Compare* FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1 (1961).

[86]Smaller investor owned distributors and municipalities — simply because of their size — may never be able to be a competitor.

[87]*E.g.*, Order No. 234-B, *FERC Statutes and Regulations*, ¶ 30,476 at 30,599.

fact, it is probably sending the wrong "signal" since it tells the producer that he need not respond to the forces of the *whole* of the gas consuming market, only to that portion capable of "sending signals."

Thus, rather than invoking "across-the-board" price reductions for the benefit of all customers, gas-for-gas competition may merely be creating a new "pool" of gas, outside the realm of rolled-in system supply, for the exclusive benefit of large industrial end-users.

As questionable as the theoretical assumptions underlying gas-for-gas competition are, the factual predicates upon which these theories rest are even more dubious. One premise that seems to permeate much of the Commission's action in this area is that the interstate pipelines are essentially the same;[88] another is that distribution companies are essentially the same;[89] and yet another is that distribution companies are essentially the same as pipeline companies.[90] If pipelines and distributors are the same, it is thought, they can compete fairly with each other.

Distributors are not all alike and certainly are not at all like interstate pipelines. If the Commission is intent on advancing gas-to-gas competition between pipelines and distributors, it must be sensitive to the basic distinctions between them.

The first, and most obvious, distinction relates to the respective service obligations of distributors. A gas distributor is organized to provide natural gas service to the whole general public in a given area. Under applicable state law, it is obligated to provide this service on a just, reasonable, non-discriminatory and non-preferential basis to all. In short, a gas distributor is a "public utility." Under the Natural Gas Act, interstate pipeline companies are not "public utilities" since there is no general obligation to serve all users in any area of service.[91] The courts have long held that the Natural Gas Act contemplates service under and pursuant to the contractual commitments of the pipeline as authorized by certificates of public convenience and necessity.[92]

A second distinction relates to the rates charged by pipelines and distributors. The Natural Gas Act enables an interstate pipeline company to file new rates which become effective after thirty days unless suspended. If these rates are suspended,

---

[88]As an example, notwithstanding the parties' intent, the Commission determined to apply the same conditions to the PanMark proposal that it had on rehearing of the Columbia, Transco, Tennessee and Tenneco proposals. PanMark Gas Co., 26 FERC ¶ 61,341 (1984). For the Commission to adopt this premise is astounding in light of its day-to-day regulation of pipelines. Northwest Pipeline Corporation and Algonquin Gas Transmission Corporation are hardly similar.

[89]The Commission's summary treatment of distributor by-pass concerns certainly reflects this assumption. *Supra* text accompanying notes 65-69 and 79-80. There is not homogeniety among distributors. There are investor owned and municipal distributors of varying size and financial capabilities. They serve different geographical locations, have different market profiles, and vary in terms of access to local gas supplies. *See, e.g.,* Fleming, Jr. and Oliver, Jr., *The Gas Distributor Approaches Deregulation,* 108 PUB. UTIL. FORT. 15 (No. 1 1981); Tiano, *Market-Ordering Devices From A Gas Distributor's Viewpoint,* 107 PUB. UTIL. FORT. 24 (No. 7 1981).

[90]The Commission's reliance on interstate pipeline filings in concluding that interruptible sales "will not have a significant impact upon the customers of the [distributor] supplier that loses the load" certainly reflects this assumption. Transcontinental Gas Pipe Line Corp., 26 FERC ¶ 61,029 at 61,056 (1984).

[91]Section 7(g) of the Natural Gas Act, 15 U.S.C. § 717f(g).

[92]*E.g.,* Permian Basin Area Rate Cases, 390 U.S. 747 (1968); United Gas Pipe Line Co. v. Mobile Gas Service Corp., 350 U.S. 332 (1956).

the pipeline may place the same in effect, under bond, after a five month period of suspension.[93] Under existing Commission regulation, a properly designed and determined PGA adjustment charge goes into effect automatically on specified dates.[94] Under many state laws, however, a distributor's new base rates may be effective only after a considerable waiting period or suspension which, in either case, may be much longer than the five-month suspension period under the Natural Gas Act. In other states, any change in base rates by the distribution utility becomes effective only at the conclusion of a rate proceeding. This process may require a year or more before new rates are instituted.

The basic difference in obligation and cost recovery in the ratemaking process is especially important in the context of special marketing programs. To the extent a distributor loses a customer under such a program, there may be a significant delay before the distributor can start recovering the fixed costs previously borne by the lost customer. Moreover, as more customers are lost, the remaining customers ultimately bear ever increasing costs of distributor operations, assuming that they are reflected in new base rates.

Equally important, a distributor, as a public utility, must stand ready to serve a lost load, in whole or in part, when such customer(s) for reasons of its own decides to renew service. Unlike the distributor, an interstate pipeline can limit its exposure by adjusting the aggregate contract demands of its customers reflected in service agreements and an interstate pipeline does not have to serve any increase of that aggregate demand. Satisfaction of any additional demands on the interstate pipeline must meet the criteria specified in Section 7(a) of the Natural Gas Act.[95] As Court of Appeals in the *Granite City Steel* case[96] said of Section 7(a):

> The theory and purpose of the statutory restriction appear to be that persons desiring gas for the first time, or desiring more gas, should not get it by taking it away from existing lawful customer.[97]

When this statutory interpretation is coupled with the Supreme Court's clear instruction that the Commission cannot favor particular natural gas users,[98] interstate pipelines are protected against demands for new service either at the whim of an end-user or of the Commission.

Unlike interstate pipelines, local distribution companies' public utility service obligation is one of constitutional dimensions. The courts have held that continued utility service is a property right within the meaning of the due process clause of the Fourteenth Amendment of the U.S. Constitution.[99] The Supreme Court in

[93]Section 4, 15 U.S.C. § 717c.

[94]18 C.F.R. § 154.38(d)(4).

[95]15 U.S.C. § 717f(a). A pipeline cannot be compelled to enlarge its transportation facilities nor be required to sell natural gas if such sale of gas would impair its ability to render adequate service.

[96]Granite City Steel Co. v. FPC, 320 F.2d 711 (D.C. Cir. 1963).

[97]*Id.* at 713.

[98]FPC v. Transcontinental Gas Pipe Line Corp., 365 U.S. 1 (1961).

[99]*See, e.g.,* Bradford v. Edelstein, 467 F. Supp. 1361, 1369 (S.D. Texas 1979); Palmer v. Columbia Gas of Ohio, Inc., 479 F.2d 153 (6th Cir. 1973); Ihrke v. Northern States Power Co., 459 F.2d 566 (8th Cir. 1972), *vacated as moot,* 409 U.S. 815 (1972); Salisburg v. Southern New England Telephone Co., 365 F.Supp. 1023 (D. Conn. 1973); Bronson v. Consolidated Edison Company of New York, Inc., 350 F.Supp. 443 (S.D. N.Y. 1972); *Cf.* Jackson v. Metropolitan Edison Co., 483 F.2d 754 (3rd Cir. 1973).

Memphis Light, Gas and Water Div. v. Craft, 436 U.S. 1 (1978), held that customer service could not be shut off without first providing adequate notice and opportunity to be heard. In contrast to the profound public utility service obligations of a distributor, the interstate pipeline has greater freedom to manage its affairs.

Because of the differences between pipelines and distributors, gas-for-gas competition between them is neither practically nor operationally feasible. Many distributors are themselves captive to only one or two pipeline suppliers.[100] As such, they are wholly dependent upon their pipeline supplier for continued service to fulfill their public utility obligation. As a practical matter, these distributors simply cannot compete with their pipeline supplier. To assure the continuation of pipeline service, they have entered into legally binding service agreements under which they are held to specific daily entitlements of natural gas.

In addition to the long-term service agreements which severely restrict the distributor's ability to compete with its interstate pipeline suppliers, the latter's transportation tariffs probably do not permit natural gas to be transported if such transported gas could cause load loss to their systems. Thus, even if the distributor was legally able to disregard its long-term purchase commitment from its pipeline supplier, it could not utilize its competitor's system to move gas to its service areas unless the tariff is altered. The pipeline, on the other hand, would not need the distributor's permission to bring gas into its service area.[101] Moreover, even assuming the pipeline could be compelled to transport such volumes, the distributor's remaining customers would be disadvantaged by paying still higher charges associated with needed (but unused) contract demand volumes. This occurs because the distributor would need to maintain a contract demand level sufficient to serve a customer seeking to renew service.

There are also purely physical reasons why many distributors cannot compete with pipelines for their local markets. By definition, local distribution companies are located wholly within a particular state and, as a result, may lack the geographical advantages enjoyed by insterstate pipelines. For example, the distributor's facilities may be far remote from any natural gas producing area. In order to move gas into their service territory, distributors must arrange for transportation with the same pipelines with which they are expected to compete for producer sales. To make matters worse, they will probably be dwarfed by the market power of the major pipelines in bidding for favorable purchase terms.

Another very severe constraint upon competition between distributors and pipelines is the likely absence of storage on the distributor's system. Unlike pipelines with the physical capability or geographical flexibility to store natural gas — either in reservoirs or by "line pack" techniques — distributors have historically depended on their pipeline supplier to perform this function. If a distributor must perform this necessary adjunct to the purchase of a large package of gas, it would either have to construct storage facilities (assuming the geology of its service area could

[100]According to the Energy Informetion Administration, over two-thirds of all distributors are served by only one pipeline. *Supra,* note 1 at 79. *Compare* American Gas Association, *Competition In The Natural Gas Industry* at 1-2 (1984) (56% of all sales for resale are to distributors with other sources of supply).

[101]Whether the interstate pipeline would need state commission approval may vary from state to state.

accommodate it) or pay another utility to store the gas. The additional costs of storage would, of course, be passed on to the distributor's customer. To the extent such costs are for the construction of facilities performing essentially a duplicative function formerly that of the interstate pipeline, it is an economic waste.

The Commission has long held, as a matter of sound public policy, that distributors should be granted a preference over interstate pipeline companies in providing service to industrial end-users.[102] Such sales protect against interruption of services to residential and small commercial customers during an emergency and provide a load balancing function within a distribution company system. These salutory benefits have been recognized by the courts.[103] Any reduction or loss of sales to industrial customers by a distributor may require the development of storage and other protective facilities whose costs are also borne by a distributor's remaining customers.

One approach that seems to balance competing interest of end-users, distributors and pipelines is to establish transportation tariffs pursuant to which distributors will act as agents for end-users and arrange for the transportation of gas with their traditional pipeline supplier.[104] All parties are "winners" under this plan. End-users will have access to potentially cheaper gas supplies and direct market signals are received by producers. Distributors, acting as agents,[105] can have first hand knowledge of the volumes to be transported and can know of potential interruption of service requiring the provision of back-up service to end-users. Concomitantly, with this information, distributors may be able to negotiate reductions in contract demands with their interstate pipeline supplier and can develop appropriate retail sale and transportation rates, thereby avoiding shifting cost responsibility among retail customers. Finally, interstate pipelines likewise will have the ability to adjust not only their gas purchase arrangements with their producer suppliers but also can adjust their tariff structure to prevent erosion of their margins and to assure the recovery of costs on a non-discriminatory basis.

In the longer term, any Commission policy which substantially increases the number of purchasers for finite gas reserves should be discouraged. Competition is a laudable goal — indeed it is national policy — but competition for competition's sake should not obscure the Commission's vision of the natural gas market. The Commission must encourage interstate pipelines to purchase gas in the field at lower prices since the ultimate allocation of these new supply acquisitions will benefit *all* of

---

[102]Panhandle Eastern Pipe Line Co., 36 F.P.C. 1107, 1109, *aff'd sub nom.* Panhandle Eastern Pipe Line Co. v. FPC, 386 F.2d 607 (3rd Cir. 1967); Northern Natural Gas Co., 33 F.P.C. 501 (1965); Southern Natural Gas Co., 25 F.P.C. 926 (1961); Transwestern Pipeline Co., 36 F.P.C. 1010, *aff'd sub nom.* California Edison Co. v. FPC, 387 F.2d 619 (3rd Cir. 1967), *cert. denied,* 329 U.S. 909 (1968).

[103]*E.g.*, Mississippi Valley Gas Co. v. FPC, 398 F.2d 395, 397 (5th Cir. 1968).

[104]This approach was adopted in a settlement agreement filed in Texas Gas Transmission Corp., Docket No. CP83-485-000. The settlement was rejected by the Commission in an order issued July 24, 1984. Texas Gas Transmission Corp., 28 FERC ¶ 61,118 (1984).

[105]As agents for end-users, a distributor should not lose its "Hinshaw" exemption under Section 1(c) of the Natural Gas Act, 15 U.S.C.§ 717(c). To qualify for the exemption, the distributor must receive gas at the state line or within the state and all gas must be consumed therein. Natural Gas Pipeline Company of America, 18 FERC ¶ 61,235 (1982). Since the distributor is an agent of the end-user, whether natural gas is received within or outside of the state makes no difference. As agent, the distributor is, in effect, the end-user.

their customers. To the extent that a distributor loses loads to either an interstate pipeline or another distributor (and which supplies are not subject to interstate pipeline curtailment), the adverse impact upon its customers is evident — higher rates.

II. Conclusion

The Commission has taken a number of steps to promote increased usage of natural gas and has attempted to experiment with programs designed to retain or regain loads lost to competing fuels. Whether these efforts will be successful remains to be seen. It is inevitable that any one program may adversely affect certain distributors more than others. As noted above, the current times pose difficult problems for regulators but theory must give way to the fundamental differences between the various segments of the natural gas industry.

As regulators of one segment, the Commission must not lose sight of the differences and, if it is concluded that structural changes are necessary, then the Commission should present its suggestions to the Congress. In the meantime, distribution companies have little alternative but to participate aggressively in shaping Commission decisions. Distributors actively assisted the implementation of Title II of the NGPA. The cooperation among pipelines, distributors, and end-users during the rulemaking process to achieve a workable incremental pricing program is a model that should be replicated. While well intentioned, the Commission appears intent upon letting competition solve the crucial issues. Regulation is supposed to be a substitute for competition and, while experiments are noble, the Commission cannot abdicate its responsibility to the marketplace. Necessity may be the mother of invention and, perhaps, that explains the proliferation of special marketing programs. The Commission, however, must be extremely sensitive to distributors and the consuming public dependent upon them for reliable service at reasonable rates. Therefore, the Commission should encourage agency arrangements which require cooperation and ultimate supervision by FERC. Such arrangements should achieve price reduction in the field that benefit all gas consumers and will allow the Commission to avoid the thorny issues associated with programs whereby end-users by-pass their traditional distributor suppliers.