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FERC ORDER NO. 451: FREEDOM (ALMOST) FOR OLD GAS

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On June 6, 1986, the Federal Energy Regulatory Commission (FERC or Commission) issued Order No. 451,¹ the latest of the Commission's recent initiatives designed to restructure its regulatory framework for the natural gas industry.² The Order adopted with modifications the proposals contained in a Notice of Proposed Rulemaking (NOPR) issued by the Department of Energy

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This article was prepared in late August 1986 while rehearing applications of Order No. 451 were pending before the Commission.

1. Order No. 451, *Ceiling Prices; Old Gas Pricing Structure*, III FERC Stats. & Regs. ¶ 30,701, 51 Fed. Reg. 22,168 (1986).

2. See, e.g., Order No. 436-A [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,675, 50 Fed. Reg. 52,217 (1985); Order No. 436, *Regulation of Natural Gas Pipelines after Partial Wellhead Decontrol*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,665, 50 Fed. Reg. 42,408 (1985); Order No. 380-C [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,607, 49 Fed. Reg. 43,625 (Oct. 31, 1984), *aff'd*, *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144 (D.C. Cir. 1985) *cert. denied sub nom. Transwestern Pipeline Co. v. FERC*, 106 S. Ct. 1969 (1986). See generally Griggs, *Restructuring the Natural Gas Industry: Order No. 436 and Other Regulatory Initiatives*, 7 ENERGY L.J. 71 (1986); Nowak & Leitch, Maryland People's Counsel: *Will it Spur Changes in FERC's Regulation of the Natural Gas Industry?*, 6 ENERGY L.J. 265 (1985); Means & Angyal, *The Regulation and Future Role of Direct Producer Sales*, 5 ENERGY L.J. 1 (1984); Mogel & Gregg, *Appropriateness of Imposing Common Carrier Status on Interstate Natural Gas Pipelines*, 4 ENERGY L.J. 155 (1983); Order No. 380-A [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,584, 49 Fed. Reg. 31,259 (1984); Order No. 380, *Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,571 (1984), 49 Fed. Reg. 22,778 (1984).

(DOE) on November 18, 1985.³

Order No. 451 revised the maximum lawful price for "old" natural gas prescribed under sections 104 and 106 of the Natural Gas Policy Act of 1978 (NGPA),⁴ and provided for the elimination of different ceiling prices for different "vintages" of interstate old gas.⁵ The Order also established procedures for the renegotiation of gas prices and/or the release of gas covered by certain contracts,⁶ and granted blanket abandonment and certificate authorization for the sale⁷ and transportation⁸ of old interstate gas released from existing contracts under these procedures.

The new ceiling price rule became effective on July 18, 1986.⁹ The negotiation procedures established by the Order take effect on November 1, 1986.¹⁰ Order No. 451 is presently before the Commission on rehearing.¹¹

The natural gas industry has undergone substantial changes in recent years attributable in large part to the interrelationship between the utility-type regulations administered by the Commission under the authority of the Natural Gas Act (NGA)¹² and the increasingly competitive thrust of the regulatory scheme mandated by the NGPA. The rigidity of the NGA regulations combined with rising gas prices authorized by the NGPA¹³ contributed to distortions in natural gas markets that arose in the early 1980's. These distortions, in turn, were threatened to be compounded by further competitive pressures resulting from the partial wellhead decontrol of natural gas prices that occurred on January 1, 1985.¹⁴ Perceiving a need to adjust its regulations to reflect this new environment, the Commission in late 1984 and early 1985 issued two Notices of Inquiry (NOI) into the implications of partial wellhead decontrol on the natural gas industry.¹⁵ Order No. 451 represents the culmination of the

3. Notice of Proposed Rulemaking, *Ceiling Prices; Old Gas Pricing Structure*, 50 Fed.Reg. 48,540 (1985).

4. Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301, 3314, 3316 (1982).

5. 18 C.F.R. §§ 271.402(c)(3) & (7), 271.602 (1986). See Order No. 451, 51 Fed. Reg. at 22,169 n.14 ("As used in this final rule, 'vintage' refers to both the separate prices set by the Commission for various categories of old flowing gas in the area and national rate cases under its [Natural Gas Act] jurisdiction prior to enactment of the NGPA, and to the NGPA's continuation of those separate prices through separate maximum ceiling prices for those categories under the NGPA."); see also *id.* at 22,179-81 nn.83-105 and accompanying text (discussing vintage).

6. Order 451, *supra* note 1, at 22,219 (to be codified at 18 C.F.R. § 270.201).

7. *Id.* at 22,221 (1986) (to be codified at 18 C.F.R. § 284.225).

8. *Id.*

9. Order No. 451, *supra* note 1, at 22,217. On July 18, 1986, however, the FERC, at the request of the United States Court of Appeals for the Eighth Circuit, stayed the effectiveness of the rule until July 30, 1986. See Final Rule, *Suspension of Effectiveness*, 51 Fed. Reg. 27,018 (1986). On July 28, 1986 the FERC denied two petitions for stay of the rule, allowing it to become effective July 30, 1986. See Order Denying Petitions for Stay of Final Rule, 51 Fed.Reg. 27,529 (1986).

10. Order No. 451, *supra* note 1, at 22,217.

11. See Order Granting Rehearing for Further Consideration, 51 Fed. Reg. 28,351 (1986).

12. Natural Gas Act, 15 U.S.C. §§ 717a-717w (1982).

13. See Order No. 451, *supra* note 1, at 22,174-75. See also 15 U.S.C. § 3311(a) (1982) (providing monthly escalation of NGPA maximum lawful prices by a formula designed to compensate for the effects of inflation).

14. Order No. 451, *supra* note 1, at 22,175-76; see also 15 U.S.C. § 3331(a) (1982).

15. Notice of Inquiry, *Interstate Transportation of Gas for Others*, IV F.E.R.C. Stats. & Regs. ¶ 35,516 (1984), 50 Fed. Reg. 114 (1985); Notice of Inquiry, *Natural Gas Pipeline Ratemaking, Risk, and*

process initiated by these NOIs.

I. BACKGROUND

A. A Brief History of Wellhead Price Regulation

In *Phillips Petroleum Co. v. Wisconsin*,¹⁶ the Supreme Court in 1954 ruled that the Federal Power Commission (FPC)¹⁷ possessed the authority to regulate wellhead sales of natural gas by producers. During the next twenty-four years, the Commission struggled to find the appropriate method for wellhead price regulation, moving first from an attempt to regulate each producer's rate, to area rates,¹⁸ and, finally, to national rates.¹⁹ What resulted from this regulatory scheme, however, was a bifurcated natural gas market, since the Commission regulated only the wellhead price of gas sold for resale in the interstate market.²⁰ Throughout the late 1960's and early 1970's, the Commission kept the rates for gas sold in the interstate market at low levels,²¹ while the price of gas sold to the intrastate market rose as demand for natural gas increased.²² Inevitably, a shortage of natural gas occurred in the interstate market, leading to widespread curtailments of deliveries by interstate pipelines.²³

The shortages occasioned by the dual market in natural gas prompted the enactment of the NGPA by Congress.²⁴ The NGPA directly addressed the disparity between interstate and intrastate gas prices by subjecting natural gas produced in both markets to wellhead price controls.²⁵ The NGPA also provided for the gradual escalation of all gas prices²⁶ and the eventual deregulation of certain categories of gas.²⁷ Finally, the NGPA authorized natural gas trans-

Financial Implication After Partial Wellhead Decontrol, IV F.E.R.C. Stats. & Regs. ¶ 35,517 (1985), 50 Fed. Reg. 3,801 (1985); Supplement to Notice of Inquiry and Notice of Public Conference, F.E.R.C. Stats. & Regs. ¶ 35,717A (1985) 50 Fed. Reg. 8,639 (1985).

16. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

17. The FPC was created in 1920 by Congress in the Federal Power Act, 16 U.S.C. § 792 (1982) and was delegated authority to regulate the sale for resale and transportation of natural gas in interstate commerce by the NGA. The FERC succeeded to the authority of the FPC in 1977 pursuant to title IV of the Department of Energy Organization Act, 42 U.S.C. §§ 7101, 7171-7177 (1982).

18. See, e.g., Opinion No. 468, 34 F.P.C. 159 (1965), *aff'd*, *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968); see generally, Order No. 451, 51 Fed. Reg. at 22,170 n.21 (listing FPC area and national rate proceedings).

19. See, e.g., Opinion No. 699, 51 F.P.C. 2,212 (1974), *aff'd*, *Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1977).

20. See 15 U.S.C. § 717a(b)(1982).

21. The FPC was required by the law to establish cost-based just and reasonable wellhead prices. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954). See H.R. Rep. No. 95-496, Part 4, 95th Cong., 1st Sess. 91, 92 (1977), ("During the period from 1969 to 1976, interstate natural gas prices for new contracts rose by more than 700 percent, from approximately 19.8 cents per Mcf to over \$1.42 per Mcf. However, during the same period, interstate natural gas prices rose at an even greater rate, from approximately 18 cents per Mcf in 1969 to as high as \$2.39 per Mcf in 1977, better than a 1,300 percent increase.").

22. *Id.*

23. Order No. 451, *supra* note 1, at 22,173.

24. *Id.*

25. See 15 U.S.C. § 3315 (1982).

26. *Id.* § 3311 (1982).

27. *Id.* § 3331 (1982).

portation between interstate and intrastate markets.²⁸

B. *The Effect of the NGPA*

The wellhead price regulation scheme established by the NGPA significantly reduced, if it did not eliminate, the distinctions between the interstate and intrastate market that existed prior to passage of the Act.²⁹ The increased prices authorized by the NGPA also provided incentives to producers to locate and develop additional gas supplies, thus alleviating gas shortages.³⁰ As the full effect of the NGPA became apparent in the early 1980's, however, these positive results were offset by an increasingly negative impact on interstate pipelines. During the shortages of the 1970's and early 1980's many pipelines had signed contracts with producers whose terms reflected a willingness to take or pay for large amounts of natural gas at high prices. As both the supply of gas offered and the price for gas demanded by producers increased by virtue of the provisions of the NGPA, interstate pipelines encountered difficulty in selling gas as a result of rising prices, warmer temperatures, and economic recession. The result in recent years has been an oversupply of natural gas.³¹

The surplus of natural gas has had serious economic consequences. Producers with supplies shut-in by pipelines face financial difficulties and have curtailed exploration for new gas reserves. Pipelines have been accumulating substantial take-or-pay obligations to producers,³² have lost markets to alternative fuels,³³ and have had the prudence of their gas purchasing practices challenged by customers.³⁴ Gas consumers have faced increasingly higher gas prices despite the surplus.³⁵

C. *The Commission's Response*

The distortions in the natural gas markets occasioned by the combination of higher gas prices and excess supply were compounded by the rigidity of the Commission's traditional regulatory scheme under the NGA. For almost half a century, virtually all natural gas in the interstate market was purchased for resale by interstate pipelines under certificates of public convenience and necessity issued by the Commission.³⁶ The construction of facilities, the transporta-

28. *Id.* §§ 3371, 3372 (1982).

29. Order No. 451, *supra* note 1, at 22,174.

30. *Id.*

31. *Id.* at 22,174-75.

32. *See id.* at 22,197 nn.219-221 and accompanying text; *see also* Order No. 436, *supra* note 2, at 42,464.

33. Order No. 451, *supra* note 1, at 22,174-75 (citing H.R. Rep. No. 814, 98th Cong., 2d Sess. (1984), Committee on Energy and Commerce, H.R. 4277, "Natural Gas Market Policy of 1984" at 22-24.

34. *See e.g.* Opinion No. 204, Columbia Gas Transmission Corp., 26 F.E.R.C. ¶ 61,034, *reh'g*, Opinion No. 204-A, 26 F.E.R.C. ¶ 61,334 (1984), *rev'd and remanded sub nom.*, Office of Consumers' Counsel v. FERC 783 F.2d 206 (D.C. Cir. 1986); Texas Gas Transmission Corp., Initial Decision, 36 F.E.R.C. ¶ 63,001 (1986).

35. Order No. 451, *supra* note 1, at 22,175.

36. *But see* Transcontinental Gas Pipe Line Corp. v. FPC, 365 U.S. 1 (1961); Air Products & Chemicals, Inc. v. FERC, 650 F.2d 687 (5th Cir. 1981); Chandeaur Pipeline Co., 42 F.P.C. 20 (1969), *remanded*, Public Serv. Comm'n v. FPC, 436 F.2d 904 (D.C. Cir. 1970), *reconsidered*, 44 F.P.C. 1747 (1970), *aff'd*,

tion of gas in interstate commerce and wholesale sales by pipelines of that gas also required certificate authorization.³⁷ Neither a producer nor a pipeline could cease sales for resale of natural gas in interstate commerce without prior permission from the Commission to abandon the sales.³⁸ The process of obtaining certificate or abandonment authorization frequently involved lengthy adjudicatory proceedings before the Commission.³⁹ This process was not well suited to respond quickly and adequately to the problem of marketing an oversupply of natural gas.

Beginning in 1982, the Commission initiated a series of measures designed to address the problems associated with higher prices and oversupply.⁴⁰ The Commission issued a policy statement concerning the "fraud and abuse" standard that governed passthrough of interstate pipelines' purchased gas costs⁴¹ and policy statements regarding the treatment for rate purposes of prepayments made by pipelines to producers in fulfillment of take-or-pay obligations.⁴² The Commission also recognized that, although the price distortions between the interstate and intrastate market had been largely resolved by the NGPA, new market distortions were arising owing to the increasing price disparity between so-called "old" natural gas that remained at low regulated prices and other categories of gas for which incentive prices were authorized.⁴³ The Commission attempted to address this problem by the issuance of a Notice of Inquiry in which it proposed to increase old gas prices.⁴⁴ That effort was abandoned, however, in the face of Congressional opposition.⁴⁵

The Commission also approved several initiatives designed to create new gas marketing opportunities by providing greater flexibility in transportation arrangements than was otherwise available under the traditional NGA regulatory scheme.⁴⁶ In 1979 and 1980, the Commission issued a series of orders providing for transportation to high-priority end-users⁴⁷ and implementing Sec-

Public Serv. Comm'n v. FPC, 463 F.2d 824 (D.C. Cir. 1972).

37. 15 U.S.C. § 717f(c) (1982).

38. *Id.* § 717f(b) (1982).

39. *See* Atlantic Refining Co. v. Public Serv. Comm'n, 360 U.S. 378, 389-90 (1959) ("cases instituted under § 5 [to review initial certificated rates] are still in the investigative stage [since 1959]."); *see also* Permian Basin Area Rate Cases, 390 U.S. 747 nn.12-13 (1968).

40. *See supra* note 2.

41. 18 C.F.R. § 2.300 (1986); *Natural Gas; Fraud Standard; Statement of Policy*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,336, 47 Fed. Reg. 6,253 (1982). Section 601(c)(2) of the NGPA, 15 U.S.C. § 3431(c)(2), permits interstate pipelines to pass through the price, deemed just and reasonable under section 601(b), 15 U.S.C. § 3431(b), to the extent it is not "excessive due to fraud, abuse, or similar grounds."

42. 18 C.F.R. § 2.103 (1986); *Take-or-Pay Provisions in Gas Purchase Contracts*, Statement of Policy [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,410, 47 Fed. Reg. 57,268 (1982); *see also*, 18 C.F.R. § 2.76 (1986); *Regulatory Treatment of Payments Made in Lieu of Take-or-Pay Obligations*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,637, 50 Fed. Reg. 16,076 (1985), *aff'd*, Order No. 436, *supra* note 2.

43. Notice of Inquiry, *Impact of the NGPA on Current and Projected Natural Gas Markets*, IV F.E.R.C. Stats. & Regs. ¶ 35,512 at 35,560, 47 Fed. Reg. 19,157 (1982).

44. *Id.*

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

46. *See generally*, Means & Angyal, *supra* note 2.

47. Final Rule, *Certification of Pipeline Transportation for Certain High Priority End Users*, [1977-1981 Regs. Preamble] F.E.R.C. Stats. & Regs. ¶ 30,049, 44 Fed. Reg. 28,425 (1979); 18 C.F.R. Part 157,

tion 311 of the NGPA.⁴⁸ The Commission convened a conference in 1982⁴⁹ and later issued a Statement of Policy which provided guidelines for "off-system" sales by interstate pipelines.⁵⁰ In Order Nos. 234-B⁵¹ and 319,⁵² the Commission provided for blanket certificates of public convenience and necessity authorizing the self-implementing transportation of gas to end-users. The Commission approved "special marketing programs" (SMPs) enabling pipelines to conduct limited-term and spot market sales of surplus gas,⁵³ and later extended SMP authority to producers⁵⁴ and marketers.⁵⁵ Finally, to encourage pipeline customers to take advantage of alternative gas supplies available as a result of these various initiatives, the Commission issued Order No. 380,⁵⁶ which essentially eliminated the "minimum commodity bill" obligations of interstate pipeline customers.

D. The Commission's Notices of Inquiry

The regulatory programs adopted by the Commission alleviated somewhat the difficulties resulting from the natural gas surplus. These measures also increased competition at the wellhead and burner tip as producers and pipelines broadened their potential markets and consumers gained access to alternative sources of supply. However, the transportation authorized by each of these measures had different jurisdictional consequences and varied in terms of authorized gas, sellers, carriers and purchasers, as well as scope and duration of authorization and reporting requirements.⁵⁷ In short, the operation of these transportation programs became increasingly complex and cumbersome as the quantity of the gas transported rose sharply.⁵⁸ Believing that an overhaul of its regulations might be necessary, the Commission in late 1984 and early 1985

Subpart E §§ 157.100-105.

48. Order No. 46, *Sales and Transportation of Natural Gas*, [1977-1981 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,081, 44 Fed. Reg. 52,179, *reh'g*, [1977-1981 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,104, 44 Fed. Reg. 66,789 (1979).

49. Notice of Informal Public Conference, No. GP82-47-000 (Aug. 6, 1982).

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

51. Order No. 234-B, [1982-85 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,476, 48 Fed. Reg. 34,872 (1983), *vacated*, Maryland People's Counsel v. FERC, 761 F.2d 780 (D.C. Cir. 1985).

52. Order No. 319, [1982-85 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,477, 48 Fed. Reg. 34,875 (1983), *vacated*, Maryland People's Counsel, 761 F.2d 780.

53. See, e.g., Columbia Gas Transmission Corp., 25 F.E.R.C. ¶ 61,220, *clarified*, 25 F.E.R.C. ¶ 61,401 (1983), *clarified and reh'g denied*, 26 F.E.R.C. ¶ 61,031 (1984), *vacated and remanded*, Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985).

54. See, e.g., Tenneco Oil Co., 25 F.E.R.C. ¶ 61,234 (1983) *reh'g granted in part and denied in part*, 26 F.E.R.C. ¶ 61,030 (Jan. 16, 1984).

55. See, e.g., Yankee Resources, Inc. 30 F.E.R.C. ¶ 61,201 (1985).

56. Order No. 380, *Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,571, 49 Fed. Reg. 22,778, *reh'g denied*, Order No. 380-A [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,584, 49 Fed. Reg. 31,259, Order No. 380-C [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,607, 49 Fed. Reg. 43,625 (1984), *aff'd* Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985) *cert. denied sub nom.*, Trunkline Gas Co. v. FERC, 106 S. Ct. 1968 (1986).

57. See generally Means & Angyal, *supra* note 2, at 5-29.

58. See, e.g., INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA, NATURAL GAS CARRIER STATUS DURING THE CURRENT TRANSITION: A CRITIQUE OF MANDATORY CONTRACT CARRIAGE (1984).

instituted a series of inquiries⁵⁹ to review transportation and other issues in view of the newly-created competitive pressures and the upcoming partial well-head decontrol of natural gas.⁶⁰

On November 16, 1984, the Commission issued Order No. 406,⁶¹ promulgating regulations governing the deregulation of certain natural gas on January 1, 1985. Among the most significant provisions of Order No. 406 was the Commission's decision that gas which was "dually-qualified" as regulated and deregulated was deemed to be deregulated on January 1, 1985.⁶² Since at that time the market price of natural gas was below most NGPA incentive prices,⁶³ the thrust of Order No. 406 was to increase the amount of deregulated natural gas that would be subject to competitive market pressures.

On December 24, 1984, the Commission issued its first NOI concerning the interstate transportation of gas for others.⁶⁴ A second NOI was issued on January 28, 1985 to examine natural gas pipeline ratemaking, risk, and other financial implications after partial wellhead decontrol.⁶⁵ Both NOIs contained numerous questions relating to price and transportation issues for which the Commission solicited opinions and information from the industry and the public. The Commission received numerous comments to the NOIs and convened several days of conferences.⁶⁶

While the NOIs were pending before the Commission, the United States Court of Appeals for the District of Columbia Circuit issued two opinions which proved to be the death-knell of the Commission's SMP and blanket certificate initiatives.⁶⁷ *MPC I* vacated an SMP approved for Columbia Gas Transmission Corporation on the basis that it was discriminatory to the pipeline's captive core customers, who were forced to pay higher gas prices because of the lack of an alternative source of supply. *MPC II* remanded Order No. 234-B to the Commission because of its similarly anticompetitive effect. The court emphasized that transportation programs authorized by the FERC must be non-discriminatory in terms of service to captive and non-captive customers.⁶⁸

59. See *supra* note 15.

60. Section 121 of the NGPA, 15 U.S.C. § 3331 (1982), provides for deregulation on January 1, 1985, of certain gas priced under NGPA §§ 102, 106(b), 15 U.S.C. §§ 3312, 3313, 3316(b) (1982).

61. Order No. 406, *Deregulation and Other Pricing changes on January 1, 1985, Under the NGPA*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,614, 49 Fed. Reg. 46,874, *reh'g denied in part and granted in part*, Order No. 406-A, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,622, 49 Fed. Reg. 50,637 (1984), *appeal filed*, Martin Oil Service, Inc. v. FERC, (No. 84-2756 10th Cir.).

62. Order No. 406, *supra* note 61, at 46,877-78.

63. *Id.* at 46,878.

64. See *supra* note 14.

65. *Id.*

66. Supplement to Notice of Inquiry and Notice of Public Conference, IV F.E.R.C. Stats. & Regs. ¶ 35,517, 50 Fed. Reg. 8,639 (Mar. 4, 1985).

67. Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1984) [hereinafter *MPC I*]; Maryland People's Counsel v. FERC, 761 F.2d 780 (D.C. Cir. 1985) [hereinafter *MPC II*].

68. See *MPC II*, 761 F.2d at 789.

II. THE PROGRESSION TO ORDER NO. 451

A. Order No. 436

Shortly after the issuance of the decisions in *MPC I* and *MPC II*, the Commission issued an NOPR in Docket No. RM85-1-000 based on the information it had received in response to its NOIs.⁶⁹ The NOPR proposed regulations in four areas designed to make the natural gas industry more competitive. First, the Commission proposed to replace its numerous existing transportation programs with one blanket certificate program that would require pipelines accepting such a certificate to transport gas on a non-discriminatory basis for owner and non-owner shippers alike⁷⁰ and to provide customers of the pipelines the option to reduce their sales entitlements over a four-year period.⁷¹ Second, the Commission proposed to grant interstate pipelines offering non-discriminatory transportation under a blanket certificate "safe harbor" treatment for payments made to extinguish take-or-pay liabilities.⁷² Third, the NOPR indicated that optional expedited certificates for new services, facilities and operations would be available for interstate pipelines willing to assume the risk of these ventures.⁷³

The fourth area addressed in the NOPR concerned the issue of price.⁷⁴ Historically, pipeline rates had been based on "rolled-in" pricing, in which the gas cost component of a pipeline's rates was based on the weighted average cost of gas. Recognizing the increasing disparity between the prices of "old regulated gas and NGPA incentive and deregulated gas, the Commission proposed to preserve the benefits of old gas for existing firm sales customers of a pipeline. This would be accomplished by a "block billing" mechanism in which gas priced under NGPA Sections 104, 106(a) and 109 (Block 1) would be available first to existing firm sales customers.⁷⁵ Block 2 would contain all other gas, the price of which would be deemed "just and reasonable" once a pipeline permitted its firm sales customers to reduce by 100 percent their contract demands for firm sales service and offered non-discriminatory transportation to those customers.⁷⁶ A third block would consist of other demand and commodity costs.⁷⁷ According to the Commission, the purpose of block billing was to remove inaccurate price signals transmitted to producers as a result of rolled-in pricing and to provide incentives for pipelines to reduce acquisition costs of gas for sale to new markets.⁷⁸

69. Notice of Proposed Rulemaking, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, IV F.E.R.C. Stats. & Regs. ¶ 33,408, 50 Fed.Reg. 24,130 (1985).

70. *Id.* at 24,135-36.

71. *Id.*

72. *Id.* at 24,147-50. Under the "safe harbor" proposal, a pipeline making qualifying payments to extinguish all minimum payment or purchase obligations in certain contracts would be presumed to have acted prudently, subject to rebuttal, for purposes of sections 4 and 5 of the NGA. *Id.* at 24,147. The presumption was available only to pipelines that agreed to offer transportation on a non-discriminatory basis. *Id.*

73. *Id.* at 24,150-52.

74. *Id.* at 24,152-54.

75. *Id.* at 24,152-53.

76. *Id.* at 24,153.

77. *Id.*

78. *Id.* at 24,152-53.

Following the receipt of public comments on the NOPR, the Commission issued Order No. 436 on October 9, 1985.⁷⁹ Order No. 436 adopted with some changes the NOPR's proposals concerning non-discriminatory blanket certificates and the optional, expedited certificate procedures. The Commission decided not to adopt its "safe harbor" proposal for take-or-pay payments.⁸⁰ The block billing proposal, which had received substantial opposition from many segments of the industry, was continued as a proposed rulemaking in revised form with additional comments solicited.⁸¹

B. The Revised Block Billing Proposal

In a Notice Requesting Supplemental Comments issued in conjunction with Order No. 436,⁸² the Commission asserted that rolled-in pricing may be unjust and unreasonable under section 5 of the NGA⁸³ because it inhibits the transmission of accurate price signals from producers to consumers.⁸⁴ The Commission stated that rolled-in pricing encourages the depletion of scarce natural resources, since customers are charged a price below the cost of replacement supplies,⁸⁵ and provides disincentives to the development of new supplies for sale in markets where cushions of old gas are not available to subsidize the production of new gas.⁸⁶ The Commission concluded that the "unlevel playing field" resulting from a rolled-in pricing system would frustrate the transportation and expedited certificate features of Order No. 436 because it would promote market raiding by pipelines that enjoyed competitive advantages simply because of greater access to low-priced, regulated gas.⁸⁷

While acknowledging the criticisms of block billing that had been advanced by commenters,⁸⁸ the Commission found that block billing would mitigate the distortions of rolled-in pricing and promote market equilibrium by better reflecting a customer's valuation of natural gas and the resource cost of producers in bringing gas to market.⁸⁹ According to the Commission, block billing would result in "a more level playing field on which pipelines may compete"⁹⁰ and would "discourage wasteful consumption of natural gas."⁹¹ The Commission also concluded that block billing would not be inconsistent with

79. Order No. 436, *supra* note 2. The FERC received approximately 300 comments on the proposed rule. *Id.* at 42,422.

80. *Id.* at 42,462. The Commission instead decided to retain the guidelines concerning a pipeline's rate treatment for such payments set forth in its April 10, 1985 Statement of Policy. *See supra* note 42.

81. Order No. 436, *supra* note 2, at 42,410, 42,423.

82. Notice of Proposed Rulemaking, *Regulation of Natural Gas Pipelines After Partial Wellhead Deregulation*, IV F.E.R.C. Stats. & Regs. ¶ 32,419, 50 Fed. Reg. 42,372 (1985) [hereinafter Block Billing NOPR].

83. 15 U.S.C. § 717c (1982).

84. Block Billing NOPR, *supra* note 82, at 42,376.

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.* at 42,377-78.

89. *Id.* at 42,376.

90. *Id.* at 42,377.

91. *Id.*

the NGPA,⁹² nor would it result in gas supply shortages or other economic inefficiencies.⁹³

The Commission therefore proposed a revised block billing rule to be phased in beginning June 1, 1986 and solicited comments on its new proposal.⁹⁴ Although there were minor changes,⁹⁵ the revised proposal was essentially the same as the original.

C. The DOE Proposal

On November 18, 1985, the date comments were due on the Commission's supplemental block billing proposal, the Secretary of Energy, pursuant to section 403 of the Department of Energy Organization Act,⁹⁶ proposed a rule for final action by the FERC to establish just and reasonable prices for "flowing" old gas and to provide incentive prices under section 107 of the NGPA for certain categories of old gas.⁹⁷ The DOE requested that the Commission act on its proposal by June 1, 1986.

The principal thrust of the DOE's proposal was to simplify the Commission's existing rate structure for flowing old gas,⁹⁸ described as gas subject to NGPA sections 104 and 106(a), by eliminating the vintaging of those prices. The DOE proposed to replace vintaged prices with one maximum lawful price equal to the highest current ceiling price for old gas (the ceiling price for post-1974 gas),⁹⁹ as escalated under current law.¹⁰⁰

In urging the Commission to raise old gas ceiling prices, the DOE asserted that the Commission's existing pricing structure for old gas created a barrier against the production of tens of trillions of cubic feet of recoverable old gas reserves, resulted in higher gas prices paid by consumers, and increased imports of oil and gas.¹⁰¹ The DOE estimated that the increased recovery of old gas reserves would provide the United States economy with over \$25 billion in benefits in the next decade.¹⁰² DOE stated that legislative decontrol of gas prices would be the best solution for problems created by the old gas pricing structure. However, in the absence of decontrol, the DOE urged the Commission not to

92. *Id.*

93. *Id.* at 42,373.

94. *Id.* at 42,389.

95. *Id.* at 42,373-74. The Commission proposed to change the base period for computing old gas allocations for existing firm sales customers, the classes of customers eligible to receive old gas allocations, and the treatment of non-gas costs.

96. Department of Energy Organization Act, 42 U.S.C. §§ 7101, 7173 (1982). Section 403(a) of the Department of Energy Organization Act provides both the Commission and the Secretary of Energy with authority to propose rules, regulations and statements of policy of general application with respect to any function within the jurisdiction of the Commission under section 402 of the Act.

97. Notice of Proposed Rulemaking, *Changes to the Old Gas Pricing Structure — Proposed Rule to Federal Energy Regulatory Commission*, 50 Fed. Reg. 48,540 (1985).

98. Flowing old gas consists of gas subject to §§ 104 and 106(a) of the NGPA governing certain gas committed or dedicated to interstate commerce prior to November 9, 1978, and gas subject to interstate rollover contracts. 15 U.S.C. §§ 3314, 3316(a) (1982).

99. See 18 C.F.R. § 271.101 (1986).

100. See 15 U.S.C. § 3301(a) (1982).

101. See 50 Fed. Reg. at 48,540.

102. *Id.*

adopt its block billing proposal, but instead to consider the DOE's proposal as a companion to the new initiatives undertaken by the Commission in Order No. 436.

The DOE emphasized that the Commission possessed considerable legal authority and discretion to establish just and reasonable natural gas prices within a "zone of reasonableness."¹⁰³ The DOE asserted that because the present system of vintaging failed to reflect replacement costs of new gas supplies, an inequity existed between the customers of old and new gas.¹⁰⁴ The DOE pointed to the great disparities between numerous vintaged ceiling prices and identified many of the same problems caused by rolled-in pricing that the Commission had discussed in its block billing rulemaking. Unlike the FERC, however, the DOE concluded that raising old gas ceiling prices instead of adopting block billing would promote a better resolution of these problems. According to the DOE, higher old gas ceiling prices would not result in higher average prices, would bring immediate benefits in increased old gas production, would cause more old gas production increases than new gas production declines, and would result in reduced oil and gas imports.¹⁰⁵

The DOE also proposed that the new ceiling price should not be received automatically by a producer, but should be available only to the extent the collection of the new ceiling price was provided for in a contract between the producer and purchaser.¹⁰⁶ In the case of existing contracts, the DOE proposed a "good faith negotiation rule" providing that a producer and purchaser must agree by good faith negotiation as to the extent a contract will operate to increase the price received by the producer.¹⁰⁷ To implement this proposal, the DOE suggested procedures that would afford producers a one-time right, exercisable at any time, to request purchasers of gas under a contract in effect on July 1, 1986 to nominate a price the purchaser was willing to pay for the gas.¹⁰⁸

Under the good faith negotiation rule proposed by the DOE, if a purchaser refused to nominate a price within 60 days of the request, the producer would be free to sell the gas elsewhere and would be released from all contractual and legal obligations to the existing purchaser.¹⁰⁹ If the purchaser nominated the highest price permitted by the existing contract, the producer would be required to continue to sell the gas to the purchaser at that price.¹¹⁰ If the purchaser nominated a price less than the highest price permitted by the contract, the producer could either accept the nominated price or refuse it and sell the gas to a new purchaser that agreed to pay the nominated price for a term of at least two years.¹¹¹ In the latter event the producer would also be released from existing contractual and legal obligations to the purchaser.

103. *Id.* at 48,541.

104. *Id.*

105. *Id.* at 48,544-45.

106. *Id.* at 48,545.

107. *Id.*

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id.*

In addition to its proposal to raise old gas ceiling prices, the DOE proposed that certain categories of old gas receive "high-cost natural gas" incentive prices pursuant to Section 107(b) of the NGPA. The DOE proposed that these incentive prices apply to gas produced from new infill wells and marginal wells that produced 120 Mcf of gas per day.¹¹² The DOE also proposed to amend the Commission's existing production enhancement rules¹¹³ to replace the incentive price and purchaser veto allowed by the rule with an escalating incentive price and the good faith negotiation rule.¹¹⁴ The DOE concluded that providing incentive prices would prevent the premature abandonment of the wells to which the incentive rules would apply.¹¹⁵

C. *The Department of Justice Alternative*

The same day that the DOE filed its proposed rule, the Department of Justice (DOJ) filed comments in the Commission's revised block billing rulemaking in which it also proposed an alternative to block billing. The DOJ agreed with the DOE that the continued control of old gas at below-market prices was the source of market distortions. The DOJ went further than the DOE, however, in recommending that the Commission adopt a rule establishing a presumption that the free market price of natural gas priced under NGPA sections 104, 106(a) and 109 constituted a just and reasonable price under the NGA.¹¹⁶ The DOJ also proposed that expedited abandonment should be granted to producers making sales under expired old gas contracts and upon the expiration of existing contracts.¹¹⁷ The DOJ stated that permitting old gas to be sold at market clearing prices would eliminate inefficiencies in the production and consumption of natural gas.¹¹⁸ The DOJ emphasized that the Commission possessed ample legal authority to establish just and reasonable rates for old gas based on market forces.¹¹⁹ Finally, the DOJ stated that while the Commission could institute its block billing proposal concurrently with the DOJ proposal, it should not do so.¹²⁰

D. *The Commission's Response to DOE and DOJ*

On December 27, 1985, the Commission issued a Notice of Procedural Schedule which established procedures for public comment on the DOE's proposal.¹²¹ The Commission specifically requested comments on the following four issues: (i) the Commission's legal authority to establish new just and rea-

112. *Id.*

113. *Id.* at 48,546.

114. *Id.*

115. *Id.*

116. *See Comments of the United States Department of Justice in Response to Notice Requesting Supplemental Comments*, filed November 18, 1985 at 25-37 [hereinafter November 18 Comments].

117. *See Comments of the United States Department of Justice*, filed February 25, 1986 at 31-33 [hereinafter February 25 Comments].

118. November 18 Comments, *supra* note 116, at 14-25.

119. *Id.* at 29-37.

120. February 25 Comments, *supra* note 117, at 34-35.

121. *See Notice of Procedural Schedule*, 50 Fed. Reg. 52,935 (1985).

sonable rates for old gas and to eliminate vintaging, and the type of record support necessary to take such action; (ii) the interrelationship between the DOE's proposal and the block billing proposal; (iii) the merits of alternative proposals such as that suggested by the DOJ; and (iv) the DOE's analysis of the old gas supply response that would occur following the adoption of the proposal.

III. ORDER NO. 451

A. *The Ceiling Price Rule*

Following the receipt of comments¹²² and a public conference,¹²³ the Commission on June 6, 1986 issued Order No. 451, which adopted the DOE's proposal with modifications. The centerpiece of Order No. 451 was a rule¹²⁴ establishing a single, alternative maximum lawful price for all vintages of gas subject to NGPA sections 104 and 106 at the price for post-1974 gas,¹²⁵ subject to an inflation factor adjustment.¹²⁶ The vintaging of old gas prices that had previously existed under the Commission's regulations was eliminated. First sellers¹²⁷ of section 104 and 106(a) gas were authorized to collect a price up to the alternative maximum lawful price, if the price was established under a contract or contract amendment executed after July 18, 1986.¹²⁸ Old natural gas produced by pipelines or pipeline affiliates was also made eligible for the new maximum lawful price,¹²⁹ subject to scrutiny under the affiliated entities test applicable to interstate pipeline passthrough.¹³⁰

122. The Commission received approximately 113 initial comments on the DOE's proposal. See Order No. 451, *supra* note 1, at 22,169, 22,221-22. The Commission also issued a Notice on February 26, 1986 providing for the filing of reply comments on the proposal. Notice Providing for Reply Comments and Establishing a Public Conference, 51 Fed. Reg. 7,583 (1986). Approximately 37 reply comments were filed. Order No. 451, *supra* note 1, at 22,169, 22,221-22.

123. A two-day public conference was held on April 10 and 11, 1986. See March 5, 1986 Notice, 51 Fed. Reg. at 7,583. Over forty interested persons participated in the conference, compiling a hearing transcript of 584 pages. Order No. 451, *supra* note 1, at 22,169, 22,221-22.

124. *Id.* at 22,220 (1986) (to be codified at 18 C.F.R. § 271.402(c)).

125. NGPA Section 109 gas was not affected by the final rule since the ceiling price for that category of gas is already at the post-1974 price. See 18 C.F.R. § 271.902 (1986).

126. The price for post-1974 gas in October 1986 has been set at \$2.593 per MMBtu. 51 Fed. Reg. 27,405 (1986).

127. Section 2(21) of the NGPA provides that:

(a) GENERAL RULE — the term "first sale" means any sale of any volume of natural gas —

- (i) to any interstate pipeline or intrastate pipeline;
- (ii) to any local distribution company;
- (iii) to any person for use by such person;
- (iv) which precedes any sale described in clauses (i), (ii), or (iii); and
- (v) which precedes or follows any sale described in clauses (i), (ii), (iii), or (iv) and is defined by the Commission as a first sale in order to prevent circumvention of any maximum lawful price established under this Act.

15 U.S.C. § 3301(21) (1982).

128. Order 451, *supra* note 1, at 22,220 (to be codified at 18 C.F.R. § 271.402(c)(7)(i)). See *supra* note 9, regarding change in effective date of Order No. 451.

129. Order No. 451, *supra* note 1, at 22,210.

130. Section 601(b)(1)(E) of the NGPA provides that any amount paid in a first sale between any interstate pipeline and any affiliate of such pipeline shall be deemed to be just and reasonable if such amount

The Commission determined in Order No. 451 that indefinite price escalator clauses in existing contracts provide the requisite contractual authority for the collection of the alternative maximum lawful price for gas subject to NGPA sections 104 and 106(a).¹³¹ By requiring that the purchaser agree to pay the higher price, however, the rule precluded the automatic effectiveness of indefinite price escalator clauses in existing contracts.¹³² Instead, if the purchaser did not agree to pay the higher price, the first seller was required to continue sales of NGPA section 104 and 106(a) gas to the purchaser under the terms of the existing contract until the first seller obtained abandonment authorization to cease sales to the purchaser under procedures established by the rule.¹³³

The alternative maximum lawful price was available to a seller of section 104 and 106(a) gas sold at the minimum rate,¹³⁴ or pursuant to fixed price clauses in existing contracts, only if and to the extent its purchaser agreed.¹³⁵ A seller of minimum rate or fixed price gas had no ability to cease sales if its purchaser refused to pay the alternative maximum lawful price.¹³⁶ The post-1974 price was also made applicable to NGPA section 106(b)¹³⁷ gas which was still regulated as to price¹³⁸ if the new price was established by a contract provision executed after the effective date of Order No. 451.¹³⁹ In other words, as with minimum rate or fixed price gas, the alternative price could not be col-

does not exceed the amount paid in comparable first sales between persons not affiliated with the interstate pipeline. 15 U.S.C. § 3431(b)(1)(E) (1982).

131. Order No. 451, *supra* note 1, at 22,168, 22,204. The record of the proceeding indicated that 85 to 90 percent of old gas contracts have indefinite price escalation clauses. *Id.* at 22,204 n.242.

132. *Id.* at 22,177.

133. The first seller must provide 30 days written notice to the purchaser to abandon sales. *Id.* at 22,219 (to be codified at 18 C.F.R. § 270.201(c)(1), (e)(4) & (f)(5)). During this 30-day period, the first seller must continue to sell the gas to the original purchaser at the existing contract price. *Id.* at 22,204.

134. "Minimum rate gas" is gas produced from a well the surface drilling of which commenced prior to January 1, 1973, and which is sold pursuant to a contract providing for a fixed rate lower than the rate otherwise applicable to the gas under *Id.* at 22,220 (to be codified at 18 C.F.R. § 271.402(c)). See 18 C.F.R. § 271.402(b)(9). The rate is \$.325 per Mcf for October 1986. 51 Fed. Reg. 27,405 (1986).

135. Order No. 451, *supra* note 1, at 22,210.

136. *Id.*

137. Intrastate rollover contract gas.

'Rollover contract' means any contract, entered into on or after the date of the enactment of this Act, for the first sale of natural gas that was previously subject to an existing contract which expired at the end of a fixed term (not including any extension thereof taking effect on or after such date of enactment) specified by the provisions of such existing contract, as such contract was in effect on the date of the enactment of this Act, whether or not there is an identity of parties or terms with those of such existing contract.

NGPA § 2(12), 15 U.S.C. § 3301(12) (1982).

138. Effective January 1, 1985, interstate rollover contract gas was deregulated pursuant to NGPA Section 121 if the price paid for the gas on December 31, 1984, or the price that would have been paid for the gas, was higher than \$1.00 per MMBtu. See Order No. 406, *supra* note 61; 18 C.F.R. § 272.103(a)(3) (1986). Intrastate rollover contract gas sold for less than \$1.00 per MMBtu on December 31, 1984 remains regulated. 18 C.F.R. § 271.601 (1986).

139. Order No. 451, *supra* note 1, at 22,221 (to be codified at 18 C.F.R. § 271.602(a)(3)). The maximum lawful price for NGPA section 106(b) gas regulated under 18 C.F.R. § 271.602(a) is the higher of the maximum lawful price per MMBtu paid under the expired contract in the month in which the rollover contract became effective, adjusted for inflation, the alternative maximum lawful price for certain intrastate rollover gas specified in Table I of 18 C.F.R. § 271.101(a) (1986), or the post-1974 price established under a contract or contract amendment executed after July 18, 1986.

lected for section 106(b) gas without purchaser concurrence.¹⁴⁰

B. Rationale for the New Ceiling Price Rule

The Commission adopted the DOE's proposal to raise the maximum lawful price for old gas because the Commission concluded that the vintaged pricing structure for old gas contributed to the market disorders that occurred under the NGPA. According to the Commission, wide disparities in NGPA wellhead prices created problems for producers selling old gas at rates below replacement cost,¹⁴¹ problems for pipelines with disparate access to old gas supplies,¹⁴² and problems for consumers subject to wide price variations at the burner tip depending on the extent of a pipeline's old gas cushion.¹⁴³ The Commission found that this structure in recent years had been partly responsible for the paradox of rising city-gate prices in the midst of a surplus of deliverability and declining demand, and transmitted the wrong market signals to gas producers and consumers.¹⁴⁴ The Commission found that continuation of the then-current wellhead pricing scheme would also adversely affect long-term supply reliability.¹⁴⁵

The Commission recognized that the old gas price system was not the only source of the problems facing the natural gas industry.¹⁴⁶ Although some commenters¹⁴⁷ had argued that these problems were due primarily to high-cost gas contracts, the Commission elected to address the distortions by raising old gas ceiling prices instead of interfering with private contractual relationships governing high-cost gas.¹⁴⁸ The Commission felt that the market itself would exert pressure on contracts outside of its direct jurisdiction and thereby lessen the

140. Order No. 451, *supra* note 1, at 22,210.

141. The Commission noted that, according to the Energy Information Administration (EIA), 2.1 Tcf of old gas out of a total of 8.4 Tcf of all gas purchased in 1984 from non-affiliated producers by interstate pipelines was priced at or below \$2.12 per MMBtu, compared to overall average wellhead prices of \$2.78 per Mcf and average new gas prices of \$3.65 per Mcf. The Commission concluded that consumers were not paying and producers of old gas were not receiving the cost of replacing depleted old gas reserves. *Id.* at 22,172.

142. The Commission found that pipelines with large old gas cushions can subsidize the prices of new and deregulated gas at levels above that which consumers would otherwise be willing to pay. *Id.* at 22,172.

143. The Commission provided as an example that, in 1984, the average residential price of gas in Washington, D.C. was \$8.05 per Mcf, while the average price in Kansas was \$4.49 per Mcf. The Commission noted that the two interstate pipelines serving Kansas had old gas cushions of 47 and 65 percent of their wellhead purchases, while the old gas cushion of the pipeline serving Washington, D.C. was only 28 percent. *Id.*

144. *Id.* at 22,175. The Commission further noted that even with a 15 percent decline in the weighted average cost of gas to interstate pipelines between February 1985 and February 1986, average monthly gas utility prices at the city-gate declined by only 5 percent during the same period. *Id.* at 22,176.

145. The EIA has reported that in 1984, proved gas reserves fell to their lowest level since 1979. *Id.* The American Gas Association has also projected a substantial decline in reserve additions under current wellhead price regulations. *Id.*

146. *Id.* at 22,183.

147. *E.g.*, Texas Gas Transmission Corporation, the American Gas Association, Associated Gas Distributors, ANR Pipeline Company. See Order No. 451, 51 Fed. Reg. at 22,181, 22,183 n.122.

148. The Commission believes that many of the contractual difficulties relating to high-cost gas are being settled. Order No. 451, *supra* note 1, at 22,183, 22,196-97.

spread between high-cost contract prices and market prices.¹⁴⁹

The Commission determined in Order No. 451 that it possessed broad authority to raise old gas prices and to eliminate vintaging under sections 104(b)(2) and 106(c) of the NGPA.¹⁵⁰ The Commission found that in view of the authorities vested in the Commission by those sections, it need not find the existing old gas ceiling price to be unjust and unreasonable in order to change it.¹⁵¹ The Commission concluded, however, that this price must be changed to the extent that it was unjust and unreasonable because of the continuing distortions caused by the price and the adverse effect of that price on reserve replacement.¹⁵²

In selecting the post-1974 price as the maximum lawful price for old gas, the Commission determined that the new ceiling should be based on the current replacement cost of old flowing gas, not the original cost of finding such gas.¹⁵³ The Commission concluded that, simply because Congress retained in the NGPA the cost-based rates established under the NGA, the Commission was not precluded from employing a different methodology to establish prices based on replacement cost and good faith negotiation, or even non-cost factors,¹⁵⁴ as long as the end result was just and reasonable. The Commission further found that there was no legislative mandate for permanent vintaging.¹⁵⁵

The Commission found the current post-1974 price¹⁵⁶ to be at the low end of the "zone of reasonableness" for sections 104 and 106(a) gas based on the discounted cash flow (DCF) methodology utilized by the FPC in Opinion Nos.

149. *Id.* at 22,183. The Commission stated that a framework for the resolution of the problem exists in the expedited abandonment procedure in Order No. 436, 18 C.F.R. § 2.77 (1986), and its April 1985 take-or-pay policy statement, 18 C.F.R. § 2.76 (1986).

150. Sections 104(b)(2) and 106(c) provide that:

The Commission may, by rule or order, prescribe a maximum lawful ceiling price, applicable to any first sale of any natural gas (or category thereof, as determined by the Commission) otherwise subject to the preceding provisions of this section, if such price is —

(A) higher than the maximum lawful price which would otherwise be applicable under such provisions; and

(B) just and reasonable within the meaning of the Natural Gas Act.

15 U.S.C. §§ 3314(b)(2), 3316(c) (1982). Section 4(a) of the NGA in turn provides that:

All rates and charges made, demanded, or received by any natural gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

15 U.S.C. § 717(c)(a) (1982).

151. Order No. 451, *supra* note 1, at 22,182.

152. *Id.* (citing *Wisconsin Gas Co. v. FERC*, 770 F.2d 1144 (D.C. Cir. 1985)).

153. Order No. 451, *supra* note 1, at 22,176.

154. *See generally id.* at 22,185-86 (citing *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944)). The Commission had earlier discussed other cases for the proposition that it possesses considerable discretion in setting just and reasonable rates. Order No. 451, *supra* note 1, at 22,171, (citing *City of Detroit v. FPC*, 230 F.2d 810 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956); *Tenneco Oil Co. v. FERC*, 571 F.2d 834 (5th Cir. 1978); *Shell Oil Co. v. FPC*, 520 F.2d 1061 (5th Cir. 1975)).

155. Order No. 451, *supra* note 1, at 22,182.

156. The post-1974 price established for the month Order No. 451 was issued was \$2.57 per MMBtu. The price has been set at \$2.593 for October 1986. 51 Fed. Reg. 27,405 (1986).

770¹⁵⁷ and 770-A.¹⁵⁸ This zone of reasonableness was based on the long-term replacement cost for gas within a range whose low point was the estimated replacement cost found in Opinion Nos. 770 and 770-A, as adjusted by the NGPA deflator,¹⁵⁹ and whose high point was an estimated DCF replacement cost suggested in the comments to the DOE's proposal.¹⁶⁰ The Commission reasoned that because the natural gas industry was "workably competitive,"¹⁶¹ allowing the pricing of regulated gas at its marginal replacement cost would ease imbalances in the exploration for and development of additional gas supplies and in the consumption of all gas supplies.

Finally, the Commission said that the current excess of gas deliverability did not affect its obligation to determine just and reasonable rates. The Commission also said that it did not, however, expect its actions to result in an immediate, dramatic increase in gas prices because the post-1974 price was only a ceiling price.¹⁶² In the near term, the Commission believed that the requirement of purchaser concurrence and the good faith negotiation rule¹⁶³ established by the order would ensure that old gas prices would remain at the lower of the market price or the regulated ceiling price.¹⁶⁴ Over the longer term, the Commission believed that Order No. 451 would decrease overall gas prices by increasing recoverable old gas reserves.¹⁶⁵ According to the Commission, competitive forces will encourage the renegotiation of high-cost gas contracts and reduce above-market new gas prices to more reasonable levels as old gas prices rise and the old gas cushion is eliminated.¹⁶⁶ The Commission also believed that the elimination of vintaging would make prices more stable.¹⁶⁷

C. The Good Faith Negotiation Rule

Order No. 451 permits collection of the alternative maximum lawful price for old gas only with the agreement of the purchaser.¹⁶⁸ If the purchaser does not agree to pay this price under an amended or new contract, the first seller must continue selling gas to the purchaser under an existing contract, subject to the ceiling prices presently established for NGPA sections 104 and 106 gas.¹⁶⁹

157. Opinion No. 770, 56 F.P.C. 509 (1976).

158. Opinion No. 770-A, 56 F.P.C. 2698 (1976).

159. See *supra* note 156.

160. The Indicated Producers estimated the replacement cost to be \$2.77 per MMBtu.

161. Order No. 451, *supra* note 1, at 22,195. The Commission stated that Congress had found so in enacting the NGPA. The Commission also pointed to declining gas prices as evidence of the competition in producer markets and consumer markets. See also *Increasing Competition in the Natural Gas Market*, The Second Report Required by Section 123 of the Natural Gas Policy Act of 1978 (January 1985).

162. See also ENERGY INFORMATION ADMINISTRATION SERVICE REPORT, AN ANALYSIS OF THE DEPARTMENT OF ENERGY'S NOTICE OF PROPOSED RULEMAKING, "CEILING PRICES, OLD GAS PRICING STRUCTURE" (May 1986).

163. See discussion *infra*.

164. See generally Order No. 451, *supra* note 1, at 22,195-22,204.

165. *Id.*

166. *Id.* at 22,196-97.

167. *Id.* at 22,202.

168. *Id.* at 22,204.

169. *Id.*

Order No. 451, however, also contains a "good faith negotiation rule"¹⁷⁰ which establishes procedures that may be utilized if the parties to an old gas contract are unable to agree to new price terms for gas subject to NGPA sections 104 or 106(a). The Commission modified the rule originally proposed by the DOE to provide more balanced negotiating rights.¹⁷¹ The Commission has delayed implementation of these procedures until November 1, 1986 to allow parties time to analyze the economic consequences of the new ceiling price rule and to engage in voluntary renegotiation of their contracts before resorting to the good faith negotiation rule.¹⁷²

The good faith negotiation rule essentially sets forth a complex convention calling for a series of offers and counteroffers in renegotiating prices under contracts covering old gas. The rule provides for the renegotiation of gas prices on a contract-by-contract basis¹⁷³ and may be utilized only once for each contract that includes old gas.¹⁷⁴ The rule applies to gas subject to NGPA sections 104 and 106(a) and sold under a contract in effect on July 18, 1986, if the contract provides authority for the first seller to collect a higher price upon establishment by the Commission of a higher maximum lawful price ("existing contract").¹⁷⁵ An "existing contract" is defined to include an expired contract pursuant to which sales of natural gas are continuing under a service obligation imposed by a certificate of public convenience and necessity.¹⁷⁶

The good faith negotiation rule is inapplicable to contracts entered into after July 18, 1986.¹⁷⁷ It cannot be used if the parties renegotiate the price or any other terms for the sale of any old gas under an existing contract after July 18, 1986, whether or not they have used the good faith negotiation procedures.¹⁷⁸ However, under an Interim Order on Rehearing issued on July 17, 1986,¹⁷⁹ the Commission amended the good faith negotiation rule to enable parties to agree in writing to preserve their rights under that rule, even though an existing contract for old gas was amended after July 18, 1986.¹⁸⁰ This amendment was made on an interim basis, subject to further consideration on rehearing, to remove a possible disincentive to the voluntary negotiation of existing contracts.¹⁸¹

The steps envisioned by the good faith negotiation rule are as follows. First, at any time after October 31, 1986, a first seller may request in writing that a purchaser nominate a price at which the purchaser is willing to continue

170. *Id.* at 22,219 (to be codified at 18 C.F.R. § 270.201).

171. As discussed *infra*, the modifications grant purchasers certain rights not proposed by DOE and subject some new gas to good faith negotiation. The Commission also declined to adopt DOE's suggestion that any contract between a first seller and a third party for the sale of gas released under the rule be for a term of at least two years.

172. Order No. 451, *supra* note 1, at 22,207, 22,209.

173. *Id.* at 22,219 (to be codified at 18 C.F.R. § 270.201(a)(1)).

174. *Id.* (to be codified at 18 C.F.R. § 270.201(a)(3)(ii)).

175. *Id.* (to be codified at 18 C.F.R. § 270.201(a)(1)).

176. *Id.* (to be codified at 18 C.F.R. § 270.201(a)(4)).

177. *Id.* (to be codified at 18 C.F.R. § 270.201(a)(1)).

178. *Id.* (to be codified at 18 C.F.R. § 270.201(a)(3)(i)).

179. Interim Order on Rehearing, 51 Fed. Reg. 26,242 (1986).

180. Order No. 451, *supra* note 1, at 22,219 (to be codified at 18 C.F.R. § 270.201(a)(3)(i)).

181. See Interim Order on Rehearing, 51 Fed. Reg. at 26,243.

buying old gas under any existing contract providing for the collection of a higher price upon establishment by the Commission of a higher maximum lawful price.¹⁸² The first seller may specify the wells or category of wells under each contract for which the first seller requests a renegotiated price.¹⁸³ The first seller may also request the purchaser to provide a current list of all of the purchaser's firm sales customers, including the name and address of an employee or agent responsible for negotiating purchases of natural gas on behalf of the customer.¹⁸⁴ The purchaser must, within 30 days after receiving the request, mail the list of customers to the first seller and must certify the completeness and accuracy of the list.¹⁸⁵

Second, within thirty days after receiving a request for nomination from the first seller, the purchaser may request in writing that the first seller nominate a price at which the first seller is willing to continue selling any gas, including the old gas for which the first seller requested a nomination, under any existing contract with the purchaser that includes old gas.¹⁸⁶ This request may encompass contracts other than those covered by the first seller's initial nomination.¹⁸⁷ Additionally, the purchaser can request the first seller to nominate a price for old gas and new gas in multi-vintage contracts, the only requirement being that the contract must include some old gas.¹⁸⁸

Third, within thirty days after receiving a request from the purchaser to nominate a price for any gas under a contract not named in the first seller's initial request, the first seller may request the purchaser to nominate a price at which the purchaser is willing to continue buying any old gas under that contract, including the old gas for which the purchaser has requested a nomination.¹⁸⁹ The rule does not provide the first seller with the ability to request a nomination with respect to new gas in multi-vintage contracts for which the purchaser may have requested a nomination.¹⁹⁰ The first seller may not request a nomination of a price for old gas under contracts not covered by its initial request if it fails to do so within thirty days after receiving a request from the purchaser covering those other contracts.¹⁹¹

The good faith negotiation rule specifically provides that a first seller's initial request for nomination of a price for old gas under a contract constitutes an offer to release the purchaser from its contractual obligation to purchase any gas, old or new, under any contract with the first seller that includes old gas, whether or not named in the initial request.¹⁹² The first seller's attempt to renegotiate the price of any old gas in any contract could thus open up for renegotiation the price of any gas in every old gas or multi-vintage contract

182. Order No. 451, *supra* note 1, at 22,219 (to be codified at 18 C.F.R. § 270.201(b)(1)(i)).

183. *Id.*

184. *Id.* (to be codified at 18 C.F.R. § 270.201(b)(1)(ii)).

185. *Id.*

186. *Id.* (to be codified at 18 C.F.R. § 270.201(b)(2)).

187. *Id.* at 22,206.

188. *Id.*

189. *Id.* at 22,219 (to be codified at 18 C.F.R. § 270.210(b)(3)).

190. *Id.*

191. *Id.* at 22,208.

192. *Id.* at 22,219 (to be codified at 18 C.F.R. § 270.201(b)(4)).

between the first seller and purchaser, as long as the contract includes some old gas.

The good faith negotiation procedure becomes even more complex after the requests for nomination are exchanged. If the purchaser does not nominate a price in writing within sixty days after receiving the first seller's initial request for nomination, the first seller may offer to sell all or part of the gas specified in its request to a new purchaser.¹⁹³ If the original purchaser nominates in writing the highest price to which the contract price could escalate, the first seller must accept the nomination and continue to sell gas to the purchaser, and all other terms of the contract continue to apply unless renegotiated.¹⁹⁴ For example, the purchaser may not change the terms by nominating the highest price for only some portion of the takes called for under the contract.¹⁹⁵ If the purchaser nominates a price lower than the highest price to which the existing contract could escalate, the first seller must accept or reject the nominated price within thirty days after receiving the nomination.¹⁹⁶

If the first seller does not accept the nominated price within thirty days, it is deemed rejected.¹⁹⁷ If the first seller accepts the nominated price, sales must continue at the agreed-upon price under the other terms of the existing contract, unless those terms are renegotiated.¹⁹⁸ The first seller must accept the purchaser's nomination in its entirety with respect to a contract and may not, for instance, partially accept the nomination for only certain categories of gas.¹⁹⁹ If the first seller rejects the nominated price, it may offer to sell all or part of the gas for which no price is agreed upon to a new purchaser.²⁰⁰ However, the first seller must continue sales to the original purchaser at the existing price until the first seller complies with certain additional procedures.

The purchaser's options in responding to a first seller's subsequent request for nomination parallel those outlined above. If the first seller does not nominate a price within sixty days after receiving the purchaser's request for nomination, the purchaser may terminate its purchases of all or part of the gas covered by its request at any time after providing thirty days written notice to the first seller.²⁰¹ If the first seller nominates a price in response to the purchaser's request, the purchaser must accept or reject the nominated price in writing within thirty days after receiving the nomination.²⁰² If the purchaser does not accept the first seller's nominated price, it is deemed rejected.²⁰³ If the purchaser accepts the nominated price, purchases must continue at the agreed-upon price under the other terms of the existing contract, unless those terms are renegotiated.²⁰⁴ If the purchaser rejects the nominated price, the purchaser may

193. *Id.* (to be codified at 18 C.F.R. § 270.201(c)(1)).

194. *Id.* (to be codified at 18 C.F.R. § 270.201(d)).

195. *Id.* at 22,178 n.75.

196. *Id.* at 22,219 (to be codified at 18 C.F.R. § 270.201(e)(1)).

197. *Id.*

198. *Id.* (to be codified at 18 C.F.R. § 270.201(e)(2)).

199. *Id.* at 22,209 n.262.

200. *Id.* at 22,219 (to be codified at 18 C.F.R. § 270.201(e)(3)).

201. *Id.* (to be codified at 18 C.F.R. § 270.201(c)(2)).

202. *Id.* (to be codified at 18 C.F.R. § 270.201(f)(1)).

203. *Id.*

204. *Id.* (to be codified at 18 C.F.R. § 270.201(f)(2)).

at anytime cease purchasing all or part of the gas named in its request upon thirty days written notice to the first seller.²⁰⁵ Once the purchaser terminates purchases of gas and the first seller enters into a written contract for the sale of the gas to a new purchaser, the first seller is authorized to abandon sales of the gas to the purchaser under procedures described below.²⁰⁶ The terms of the existing contract apply until the purchaser accepts the first seller's nominated price or terminates purchases.²⁰⁷

In summary, the good faith renegotiation rule authorizes a first seller to abandon sales of old gas to its purchaser under an existing contract when (i) the purchaser does not nominate a price within sixty days after receiving the first seller's initial request for nomination; (ii) the first seller rejects the purchaser's nominated price, (iii) the purchaser terminates purchases because the first seller does not nominate a price in response to the purchaser's request; or (iv) the purchaser terminates purchases after rejecting the first seller's subsequent nominated price. However, the good faith negotiation rule imposes yet another requirement before the first seller can obtain abandonment and make sales of old gas to a new purchaser.

If the first seller offers to sell gas subject to release resulting from any of the four circumstances outlined above to a new purchaser that is not an existing firm sales customer of the existing purchaser, the first seller must first present the same offer to all existing firm sales customers of the existing purchaser if (i) the existing purchaser is not subject to the non-discriminatory transportation provisions of Order No. 436; (ii) the offer encompasses the sale of gas subject to the Commission's NGA jurisdiction; and (iii) the offer has been substantially accepted in principle by the new purchaser in an arms-length transaction.²⁰⁸ The offer must be mailed to existing firm sales customers of the existing purchaser not later than ten days after the offer is accepted in principle by the new purchaser.²⁰⁹ Any firm sales customer has a right of first refusal to the gas under the terms of the offer.²¹⁰

An existing firm sales customer has twenty days in which to accept the offer.²¹¹ If more than one existing firm sales customer accepts the offer, the first seller may determine which customer will become the new purchaser.²¹² If the offer is not accepted by an existing firm sales customer within twenty days of receipt, it is deemed rejected.²¹³ If no existing firm sales customer accepts the offer, the first seller may execute a written contract with the new purchaser

205. *Id.* at 22,220 (to be codified at 18 C.F.R. § 270.201(f)(3)).

206. *Id.* (to be codified at 18 C.F.R. § 270.201(f)(5)).

207. *Id.* (to be codified at 18 C.F.R. § 270.201(f)(4)).

208. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(1)). "Existing firm sales customer" is defined in 51 Fed. Reg. at 22,220 (to be codified at 18 C.F.R. § 270.201(g)(5)) as a customer with which the existing purchaser has a contract for the sale of gas not subject to a prior claim by another customer or another class of service, which is in effect on the date a new purchaser substantially accepts an offer in principle.

209. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(2)).

210. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(1)(ii)).

211. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(3)(i)). The offer is deemed accepted when it is signed and placed in the mail, return receipt requested. *Id.*

212. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(3)(iii)).

213. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(3)(i)). Any written counteroffer also constitutes a rejection. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(3)(ii)).

that substantially accepted the offer in principle.²¹⁴ This written contract is not subject to a right of first refusal.²¹⁵

If the offer made by the first seller to the new purchaser encompasses both NGA and non-NGA gas, the right of first refusal must apply to the entire stream of gas included in the offer.²¹⁶ However, the right of first refusal requirement is applicable only if the existing purchaser of the first seller is a pipeline that has not accepted the non-discriminatory access provisions of Order No. 436. The Commission reasoned that this right need not be provided to existing firm sales customers of pipelines that have accepted the Order No. 436 conditions, since those customers have greater assurance of obtaining transportation of released gas purchased directly from the first seller.²¹⁷

D. Abandonment of Gas Released Under the Good Faith Negotiation Rule

Once a first seller completes the requirements of the good faith negotiation rule and, if applicable, the right of first refusal, the first seller may abandon some or all sales of gas to its existing purchaser without the need for further application or hearing.²¹⁸ Any portion of the sales to the existing purchaser not abandoned must continue in accordance with the terms of the existing contract between the parties and may not be subsequently abandoned under the good faith negotiation rule.²¹⁹ A first seller that is authorized to abandon sales of gas under this program is automatically granted a blanket certificate of public convenience and necessity to sell the gas for resale in interstate commerce. It is also the recipient of pre-granted abandonment of any subsequent sale for resale upon termination of the contract under which the sale is made.²²⁰

The Commission waived its rate filing requirements²²¹ for first sellers that make sales under the blanket certificate authority described above.²²² However, a first seller that makes sales under that blanket certificate authority must, in January or February of each year, file a report with the Commission on any sales under the certificate initiated during the preceding calendar year.²²³

E. Transportation of Gas Released Under the Good Faith Negotiation Rule

Order No. 451 provides that an existing purchaser that is an interstate pipeline not subject to the non-discriminatory access provisions of Order No. 436 will be deemed to have agreed to transport upon thirty days notice any released gas, if the pipeline (i) does not nominate a price for gas in response to

214. *Id.* (to be codified at 18 C.F.R. § 270.201(g)(4)).

215. *Id.*

216. *Id.* at 22,207.

217. *Id.*

218. *Id.* at 22,205-06.

219. *Id.* at 22,209.

220. *Id.* at 22,218 (to be codified at 18 C.F.R. § 157.301(a) and (b)).

221. 18 C.F.R. §§ 154.92 & 154.94 (1986).

222. Order No. 451, *supra* note 1, at 22,218 (to be codified at 18 C.F.R. § 157.301(d)).

223. *Id.* (to be codified at 18 C.F.R. § 157.301(c)). The report must contain the following information: Name of former purchaser, name of new purchaser, location of sale, contract date, contract term, average price and estimated annual sales volume.

a first seller's request for nomination; (ii) nominates a price less than the highest price to which its existing contract could escalate; (iii) terminates purchases of gas when the first seller does not submit a timely nomination of a price; or (iv) terminates purchases of gas after rejecting a price for gas nominated by the first seller.²²⁴ The terms and conditions of the transportation service provided must conform to the transportation requirements of the shipper, subject to reasonable operating conditions of the pipeline and its available pipeline capacity.²²⁵ An interstate pipeline that transports gas under this provision does not otherwise become subject to the non-discriminatory access provisions of Order No. 436.²²⁶

The Commission considered this transportation obligation imposed on an interstate pipeline not subject to Order No. 436 to be a condition of the pipeline's ability to avoid its contractual obligations by means of the good faith negotiation rule.²²⁷ The Commission viewed this obligation as the only way to make the renegotiation process and the right of first refusal meaningful and to insure that gas prices are subject to competitive pressures.²²⁸ The Commission cautioned that it will consider any refusal to transport to be an unduly discriminatory and preferential practice in violation of the NGA, as well as a violation of the antitrust laws.²²⁹ If the pipeline transporting gas subsequently becomes a non-discriminatory transporter under Order No. 436, the pipeline's authority and service obligation to transport gas purchased under a contract in effect before the pipeline becomes subject to Order No. 436 will continue until the contract expires or is terminated.²³⁰

The rule provides that, in the case of transportation to an existing customer which does not exceed firm existing contract demand by that customer, the pipeline must base its transportation rate on the transmission, storage and gathering components, as appropriate, of the commodity charge in the sales rate schedule applicable to that customer, and must credit the volumes of gas transported against any minimum commodity bill obligation.²³¹ For transportation to existing customers in excess of contract demand and service to other customers, the transportation rate must be the rate in a transportation rate schedule on file with the Commission that conforms to section 284.7 of the Commission's regulations, and also conforms to either section 284.8(d) for firm service or section 284.9(d) for interruptible service.²³² Until these latter rates become effective, the pipeline must use the rate in one of its filed transportation rate schedules which the pipeline determines covers service comparable to the transportation service authorized.²³³

224. *Id.* at 22,220 (to be codified at 18 C.F.R. § 270.201(h)). Such transportation is to be on behalf of any shipper, to any existing customer of the interstate pipeline, or to any interstate, intrastate or Hinshaw pipeline to which the interstate pipeline is connected. *Id.*; see also *id.* at 22,213.

225. *Id.* at 22,221 (to be codified at 18 C.F.R. § 284.225(f)(1)).

226. *Id.* (to be codified at 18 C.F.R. § 284.225(f)(2)); see also *id.* at 22,178.

227. *Id.* at 22,212.

228. *Id.*

229. *Id.* at 22,213.

230. *Id.* at 22,221 (to be codified at 18 C.F.R. § 284.225(f)(3)).

231. *Id.* (to be codified at 18 C.F.R. § 284.225(d)(1)(i) and (ii)).

232. *Id.* (to be codified at 18 C.F.R. § 284.225(d)(2)).

233. *Id.*

F. Block Billing

The Commission concluded in Order No. 451 that the actions taken by that order and the block billing proposal were to a large extent mutually exclusive.²³⁴ The Commission did not terminate the block billing proposal, however, stating that it will review the proposal in light of the operation of Order No. 451 and will take such further action found to be reasonable or necessary.²³⁵

G. The DOJ's Alternative Proposal

The Commission considered in Order No. 451 the DOJ's proposal to declare any market price paid for gas subject to NGPA sections 104, 106 and 109 to be just and reasonable. The Commission found that this proposal would effectively deregulate old gas prices, an action that was beyond the authority provided the Commission in the NGPA.²³⁶ The Commission therefore declined to adopt the DOJ's proposal.

H. The DOE's Incentive Price Proposal

Finally, the Commission addressed the portion of the DOE's proposal that would have established an incentive ceiling price under NGPA section 107 for certain old gas for which recovery involves "extraordinary risks or costs," such as production enhancement projects, new infill wells, and existing low production or "marginal" wells.²³⁷ The Commission concluded that open issues remain with respect to the basis for this portion of DOE's proposal, and stated that it would rule on this issue in a separate order at a later date.²³⁸

I. Subsequent Developments

As noted, the Commission on July 17, 1986, issued an interim order on rehearing which amended Order No. 451 to permit parties to amend contracts while preserving their rights under the good faith negotiation rule.²³⁹ The Commission specified that its interim order on rehearing was not to be construed as a final action on the merits of any application for rehearing of Order No. 451.²⁴⁰ On July 3 and 7, 1986, the Commission received a total of sixty timely requests for rehearing of Order No. 451²⁴¹ which, at this writing, are pending before the Commission. On August 4, 1986, the Commission issued a "tolling order" granting rehearing of Order No. 451 solely for the purpose of further consideration.²⁴²

On July 1, 1986, KN Energy, Inc. (KN) filed a petition with the United States Court of Appeals for the Eighth Circuit for a writ of prohibition or a

234. *Id.* at 22,210-11.

235. *Id.*

236. *Id.* at 22,211.

237. *Id.*

238. *Id.*

239. Interim Order on Rehearing, 51 Fed. Reg. 26,242 (1986).

240. *Id.* at 26,243.

241. Order Granting Rehearing for Further Consideration, 51 Fed. Reg. 28,351 (1986).

242. *Id.*

writ of mandamus directing the Commission to vacate Order No. 451.²⁴³ KN argued that Order No. 451 was unlawful and in blatant disregard of the Commission's jurisdiction in "deeming" non-Order No. 436 interstate pipelines to be common carriers under the good faith negotiation rule.²⁴⁴ KN also objected to the procedure in Order No. 451 permitting producers to abandon gas sales if a purchaser refused to pay a nominated price following good faith negotiation.²⁴⁵ KN contended that such generic abandonment denied the opportunity for a hearing before abandonment can be granted as required by section 7(b) of the NGA.²⁴⁶ On July 3, 1986, KN also filed with the Commission an application for rehearing of Order No. 451, requesting the Commission to vacate the order or, alternatively, to stay its effectiveness pending review of KN's petition by the Eighth Circuit.²⁴⁷ KN filed a similar motion for stay with the Eighth Circuit on July 17, 1986.²⁴⁸

Order No. 451 initially was due to become effective on July 18, 1986. On that date, however, the Commission, at the request of the Eighth Circuit, stayed the effectiveness of Order No. 451 until July 30, 1986.²⁴⁹ The Commission made it clear that it was doing so only as a "matter of comity and based on our desire to accommodate the court" and "without in any way changing our view as to the merits of KN Energy's petition and motion."²⁵⁰ The Commission had several days earlier filed a response opposing KN's petition before the Eighth Circuit, arguing that mandamus was not warranted because adequate remedies existed under the usual judicial review process.²⁵¹

On July 28, 1986, the Commission issued an order denying petitions filed by KN and others for a stay of Order No. 451.²⁵² The Commission found that implementation of Order No. 451 would not cause imminent irreparable harm to the petitioners, and that delaying the effectiveness of the order would adversely affect the reliability of gas supplies to consumers and could result in the permanent loss of reserves.²⁵³ On July 31, 1986, the Eighth Circuit also de-

243. In re KN Energy, Inc., On Petition for Writ of Prohibition or Alternatively a Writ of Mandamus Directed to the Federal Energy Regulatory Commission Vacating Order No. 451, No. 86-1806 (8th Cir. filed July 1, 1986) [hereinafter KN Petition].

244. KN Petition, *supra* note 243, at 15-21.

245. *Id.* at 21-26.

246. *Id.*

247. Application of KN Energy, Inc. for Rehearing of Order No. 451 and Petition of KN Energy, Inc. for an Order Vacating Order No. 451 or Alternatively Staying the Effectiveness of Order No. 451 Pending Judicial Review, No. RM86-3 (filed July 3, 1986) [hereinafter KN Application].

248. Motion of KN Energy, Inc. for a Stay of Order No. 451 Pending (A) Disposition by This Court of Petition of KN Energy, Inc. for a Writ of Prohibition or Alternatively a Writ of Mandamus, and (B) Disposition by the Federal Energy Regulatory Commission of Application of KN Energy, Inc. for Rehearing of Order No. 451 (filed July 17, 1986).

249. Final Rule, *Suspension of Effectiveness*, 51 Fed.Reg. 27,018 (1986).

250. *Id.*

251. See In re KN Energy, Inc., Response of the Federal Energy Regulatory Commission Opposing a Petition for a Writ of Prohibition or Mandamus to Vacate Commission Regulations, No. 86-1806 at 16-22 (8th Cir.). The Commission also argued that KN failed to show that it would suffer irreparable harm absent judicial action on its petition. *Id.* at 22-25.

252. Order Denying Petitions for Stay of Final Rule, 51 Fed. Reg. 27,529 (1986). A request for stay of Order No. 451 was also filed on July 7, 1986, by certain Florida cities. See *id.* at 27,530.

253. *Id.* at 27,530-31.

clined to stay Order No. 451, finding that KN did not make a sufficient showing of irreparable harm.²⁵⁴

Finally, the Eighth Circuit on August 19, 1986, denied KN's petition for a writ of prohibition or mandamus.²⁵⁵ The court found that KN had not sustained its burden of showing that the normal administrative and judicial review processes would be ineffective.²⁵⁶ The court stated that KN may seek a stay or other relief from Order No. 451 if final action is not taken by the Commission by November 1, 1986, the effective date of the good faith negotiation rule. The court also indicated, however, that venue may not be proper in the Eighth Circuit and suggested that a more appropriate forum might be the Tenth Circuit or the District of Columbia Circuit.²⁵⁷

IV. REHEARING OF ORDER NO. 451

Order No. 451 should result in benefits from the wellhead to the burner tip if the regulatory changes brought by that order operate as predicted by the Commission and the order survives judicial review relatively intact. Producers with old gas reserves will obtain additional revenue for exploration and development of gas reserves. Customers will benefit from increased competition and may pay lower gas prices, free from regional disparities, as they gain access to alternative sources of supply and transportation through Order Nos. 451 and 436. The competitive pressures of a wide-open market may also benefit pipelines with increased throughput and the settlement of take-or-pay disputes with producers in exchange for the pipelines' agreement to pay higher old gas prices. Producers may also be persuaded to renegotiate high-cost gas contracts as old gas prices rise, in order to take advantage of increased marketing opportunities for their gas.

These phenomena will occur, however, only if the new rules work. Much of the regulatory change in Order No. 451 is premised on assumptions by the Commission on how the market will operate and how various industry segments will act and react. If the Commission's assumptions prove incorrect, the benefits predicted from Order No. 451 may not occur.

Because of its impact on the gas industry and its controversial nature, Order No. 451 is almost certain to be appealed. The petitions for rehearing of Order No. 451 filed with the Commission are critical of virtually all aspects of the order.²⁵⁸ The issues raised in those petitions presage the arguments that

254. In re KN Energy, Inc., No. 86-1806 (July 31, 1986) (order denying stay).

255. In re KN Energy, Inc., No. 86-1806 (8th Cir. August 19, 1986) (per curiam) (order denying petition for writ of prohibition or mandamus).

256. *Id.* at 3.

257. *Id.* at 1-2.

258. See, e.g., KN Application, *supra* note 247; Request of American Gas Ass'n for Rehearing of Order No. 451 (filed July 3, 1986) [hereinafter AGA Request]; Florida Cities' Requests for Rehearing and Stay of FERC Order No. 451 (filed July 7, 1986) [hereinafter Florida Cities' Request]; Request of El Paso Natural Gas Co. for Rehearing (filed July 7, 1986) [hereinafter El Paso Request]; Request of the Associated Gas Distribs. for Rehearing of Order No. 451 (filed July 7, 1986) [hereinafter AGD Request]; Request of Northern Natural Gas Co., Div. of Enron Corp. for Rehearing (filed July 7, 1986) [hereinafter Northern Request]; Request for Rehearing of Maryland Peoples' Counsel and the National Ass'n of State Util. Consumer Advocates (filed July 7, 1986) [hereinafter MPC Request].

will be raised before a reviewing court if the Commission's order on rehearing of Order No. 451 affirms it without substantial change.

A. Can the Commission Raise Old Gas Ceiling Prices and, If It Can, Should It?

The reliance on market forces in Order No. 451 and the Commission's adoption of replacement cost in establishing the new ceiling price for old gas are consistent with the philosophy of the Reagan Administration that federal regulators should allow competition to work. However, on rehearing, many petitioners have challenged the Commission's authority to increase old gas ceiling prices on these bases.²⁵⁹ Pipelines and their customers²⁶⁰ in particular have claimed that the establishment of an old gas ceiling price at or above the market price for natural gas is a *de facto* deregulation that is beyond the authority provided to the Commission by the NGA and the NGPA. These petitioners also have argued that Congress adopted, in the NGPA, the Commission's earlier policy vintaged old gas rates, and that the elimination of vintaging is a matter for the Congress and not the Commission to decide.²⁶¹

The petitions for rehearing also objected to the Commission's use of replacement cost and non-cost factors in establishing the new ceiling price for old gas. The petitioners pointed to a number of cases²⁶² holding that the Commission must use a methodology based on historical costs in establishing old gas ceiling prices. These petitioners further claimed that any departure from cost-based rates must be specifically justified.²⁶³ They argued that the Commission had prejudged the issue by failing to consider the historical costs for old gas production. The petitioners concluded that the record of the proceeding that culminated in Order No. 451 was therefore not adequate to permit the Commission to justify the use of the replacement cost methodology.²⁶⁴

Pipelines and their customers also questioned the Commission's finding that an increase in old gas prices will increase development of old gas reserves, again pointing to an alleged lack of record evidence to support this finding.²⁶⁵

259. See, e.g., KN Application, *supra* note 247, at 13-19; Northern Request, *supra* note 258, at 5-13; Florida Cities' Request, *supra* note 258, at 5-6; MPC Request, *supra* note 258, at 4-13; Application of the Public Serv. Comm'n of D.C. for Rehearing of Order No. 451 at 6-13 (filed July 7, 1986) [hereinafter DCPSC Request]; Application for Rehearing of the State of Michigan and the Michigan Pub. Serv. Comm'n (filed July 7, 1986).

260. *Id.*

261. See, e.g., Florida Cities' Request, *supra* note 258, at 5-6; Northern Request, *supra* note 258, at 6; KN Application, *supra* note 247, at 13-17.

262. FPC v. Hope Natural Gas Co., 320 U.S. 591 (1944); City of Detroit v. FPC, 230 F.2d 810 (D.C. Cir. 1955); Public Serv. Comm'n v. Mid-Louisiana Gas Co., 463 U.S. 319 (1983); Farmers Union Cent. Exch. v. FERC, 734 F.2d 1486 (D.C. Cir. 1984).

263. See, e.g., AGA Request, *supra* note 258, at 5-10; AGD Request, *supra* note 258, at 2-8; Northern Request, *supra* note 258, at 27-38; Florida Cities' Request, *supra* note 258, at 6-18; Petition of Interstate Natural Gas Ass'n of Am. for Rehearing and Clarification at 4-12 (filed July 7, 1986) [hereinafter INGAA Petition].

264. *Id.*; see also Joint Request by Natural Gas Pipeline Co. of Am. and United Gas Pipe Line Co. for Rehearing and Clarification at 15 [hereinafter Natural/United Request].

265. See, e.g., Northern Request, *supra* note 258, at 27-30; Request for Rehearing of Order No. 451 of Texas Gas Transmission Corp. at 2 (filed July 7, 1986) [hereinafter Texas Gas Request]; AGA Request,

They contended that the only beneficiaries of Order No. 451 are producers with substantial old gas reserves, who will obtain a windfall from an increase in old gas prices. The petitioners argued that there is no evidence that these producers will use their increased revenues to develop new reserves.

Finally, pipelines and their customers questioned whether Order No. 451 will provide producers holding high-cost gas contracts any real incentive to renegotiate the price or delivery terms of their present contracts.²⁶⁶ The petitioners generally viewed as speculative the Commission's position that an increased supply of old gas at higher prices will exert pressure on high-cost gas producers to lower prices or grant take-or-pay concessions.

Not surprisingly, producers generally were supportive of the Commission's order. Some producers have, however, argued on rehearing that eligibility for the new price should be automatic under area rate clauses, since it does not constitute some type of special price for which a further showing of eligibility is required.²⁶⁷ They have also raised questions as to whether the requirement that the new price be contractually authorized will result in the type of protracted controversies over the meaning of contractual authority that the Commission previously faced in Order No. 23.²⁶⁸

B. Will the Good Faith Negotiation Rule Work?

Pipelines and their customers on rehearing harshly criticized the good faith negotiation rule. They claimed that the rule violates the *Mobile-Sierra* doctrine,²⁶⁹ which prohibits a natural gas company²⁷⁰ from unilaterally changing its contracts. They argued further that a time limit should be imposed on producers to invoke the rule.²⁷¹ Most importantly, the pipelines and their cus-

supra note 258, at 10-17; MPC Request, *supra* note 258, at 24-30; Florida Cities' Request, *supra* note 258, at 19-21.

266. *Id.*

267. See Application for Rehearing of Atlantic Richfield Co., Chevron U.S.A. Inc., Cities Service Oil and Gas Corp., Exxon Corp., Hunt Oil Co., Mobil Oil Corp., *et al.*, Sun Exploration and Prod. Co., *et al.* and Union Oil Co. of Cal. at 10-16 (filed July 7, 1986) [hereinafter ARCO, *et al.* Application], *distinguishing* Pennzoil Co. v. FERC, 671 F.2d 119 (5th Cir. 1982). In *Pennzoil*, the court affirmed an eligibility requirement imposed by the Commission for NGPA section 107(c)(5) tight formation gas that there be a "negotiated contract price" term in the contract between the first seller and the purchaser. The court found that the Commission had a duty to define the gas qualifying for a special price. 671 F.2d at 125. ARCO argued that Congress did not grant the Commission this type of authority to define further eligibility criteria for NGPA Sections 104 and 106 gas for which a special price was not provided. *Id.*

268. See Request of Indep. Petroleum Ass'n of Am. for Rehearing of Order No. 451 at 3-4 (filed July 7, 1986) [hereinafter IPAA Request].

269. See MPC Request, *supra* note 258, at 32 (citing United Gas Pipeline Co. v. Mobile Gas Serv. Corp., 350 U.S. 332 (1958); FPC v. Sierra Pac. Power Co., 350 U.S. 358 (1956)).

270. A "natural gas company means a person engaged in the transportation of natural gas in interstate commerce, or the sale in interstate commerce of such gas for resale." NGA § 2(b), 15 U.S.C. § 717a(6) (1982).

271. See, e.g., Natural/United Request, *supra* note 264, at 12-13; El Paso Request, *supra* note 258, at 15-16; AGA Request, *supra* note 258, at 25-27; DCPSC Request, *supra* note 259, at 5; INGAA Petition, *supra* note 263, at 16. The petitioners argue that pipeline purchasers will be unable to make rational purchasing decisions if producers have complete discretion to invoke the good faith negotiation rule at any time.

tomers strenuously argued that the rule should apply to all new gas,²⁷² not only to new gas in multi-vintage contracts with a producer that has initiated the good faith negotiation procedures. Moreover, they believed that purchasers should have the right to initiate the negotiation process under the rule.²⁷³

Pipelines and others also asked the Commission to address certain take-or-pay issues arising under contracts that may be the subject of good faith negotiation. In particular, they sought assurance that future take-or-pay obligations under a contract would be cancelled if a producer begins sales to a third party (new purchaser) under the rule.²⁷⁴ Some also argued that outstanding take-or-pay obligations should be suspended or cancelled and any take-or-pay prepayments refunded under these circumstances.²⁷⁵ At a minimum, they suggested, the good faith negotiation rule should not apply to contracts under which take-or-pay prepayments have been made.

Producers raised a number of issues with respect to the good faith negotiation rule. Some argued that the Commission lacked the authority to regulate new gas prices by subjecting multi-vintage contracts to the rule.²⁷⁶ They asked the Commission for further clarifications to avoid anticipated disputes as to whether a purported multi-vintage contract actually includes some old gas, a necessary predicate for bringing those contracts within the rule.²⁷⁷ One producer asked the Commission to amend the rule to prohibit a purchaser from agreeing to a new price under the rule and subsequently lowering that price under a market-out clause.²⁷⁸ Finally, producers requested the Commission to define further the terms "purchaser" and "first seller" in order to clarify the entity or entities whose contracts may be subject to the rule.²⁷⁹

The petitions for rehearing also addressed the provision of the rule granting a right of first refusal for released gas to existing firm sales customers of non-Order No. 436 pipelines.²⁸⁰ The petitioners argued that customers of Order No. 436 pipelines should also have this right of first refusal.²⁸¹ Pipelines also asked for this change.²⁸² On the other hand, a group of industrial gas users

272. See, e.g., Texas Gas Request, *supra* note 265, at 7-8; Natural/United Request, *supra* note 264, at 7-11; AGA Request, *supra* note 258, at 28-32; El Paso Request, *supra* note 258, at 4-11; DCPSC Request, *supra* note 259, at 4-5; AGD Request, *supra* note 258, at 9. "New gas" is gas not subject to the Commission's NGA jurisdiction, including gas priced under NGPA sections 102 and 103 and deep section 107 gas.

273. See, e.g., Natural/United Request, *supra* note 264, at 9-10; Texas Gas Request, *supra* note 265, at 7; AGA Request, *supra* note 258, at 21-25; AGD Request, *supra* note 258, at 15.

274. See, e.g., El Paso Request, *supra* note 258, at 14-16; INGAA Petition, *supra* note 263, at 16.

275. See, e.g., AGA Request, *supra* note 258, at 32-34; El Paso Request, *supra* note 258, at 14-15, 18; Natural/United Request, *supra* note 264, at 12.

276. See, e.g., ARCO, *et al.* Application, *supra* note 267, at 7-10, 16-20.

277. See, e.g., IPAA Request, *supra* note 268, at 2-3.

278. See Application for Rehearing of Plains Petroleum Co. (filed July 3, 1986).

279. See Request of Samson Resources Co. for Clarification or Rehearing of Order No. 451 (filed July 7, 1986).

280. Order No. 451, *supra* note 1, at 22,220 (to be codified at 18 C.F.R. § 270.201(g)(1)(ii)).

281. See, e.g., AGD Request, *supra* note 258, at 16; El Paso Request, *supra* note 258, at 11-14; Natural/United Request, *supra* note 264, at 13-14; AGA Request, *supra* note 258, at 38-40; INGAA Petition, *supra* note 263, at 17.

282. See, e.g., Natural/United Request, *supra* note 264, at 13-14. Additionally, one pipeline is attempting to avoid this limitation of the right of first refusal to customers of non-Order No. 436 pipelines in

argued that the right of first refusal provided in Order No. 451 grants an undue preference to a pipeline's customers, principally local distribution companies.²⁸³ These industrials contended that end-users will have little incentive to negotiate favorable contracts with sellers if the agreement would be lost through the exercise by a distributor of its right of first refusal.

Many pipelines and their customers argued that the Commission lacked authority to compel non-Order No. 436 pipelines to transport, thereby effectively transforming these pipelines into common carriers.²⁸⁴ The petitioners noted that this requirement was inconsistent with Order No. 436, where non-discriminatory blanket certificates were made voluntary because of the Commission's concern over its authority to compel carriage.²⁸⁵ One producer petitioner expressed concern about the availability of pipeline capacity for gas released under the good faith transportation rule and asked the Commission to provide further assurances that the capacity would be available.²⁸⁶

Finally, many petitioners for rehearing challenged the Commission's statutory authority to grant automatic abandonment of old gas released under the good faith negotiation rule.²⁸⁷ These petitioners argued that the Commission is obligated by section 7(b) of the NGA to convene hearings on a case-by-case basis before determining that the abandonment of old gas is in the public interest. They also expressed concerns regarding the security of a pipeline's supply if automatic abandonment of old gas were permitted.²⁸⁸

V. DISCUSSION²⁸⁹

The Commission believes that Order No. 451, in conjunction with the transportation initiatives of Order No. 436, will benefit all segments of the industry and the gas consuming public.²⁹⁰ Only time will tell, however, whether these orders will encourage competition and result in the market-based environment envisioned by the Commission.

Natural gas producers in general should welcome the change from a

its Order No. 436 settlement offer presently before the Commission. Northwest Central Pipeline Corporation has proposed that the effectiveness of its settlement would be deferred if it is not afforded a right of first refusal, superior to any right of first refusal that its customers may have, for any gas subject to abandonment under Order No. 451. See 34 F.E.R.C. ¶ 61,029 (1986); 35 F.E.R.C. ¶ 61,216 (1986). Docket Nos. RP86-32 and RP86-68.

283. Request for Rehearing of Order No. 451 by the Process Gas Consumers Group, the American Iron and Steel Institute and the Georgia Industrial Group at 4-7 (filed July 3, 1986).

284. See, e.g., KN Application, *supra* note 247, at 20-25, 30-36; Texas Gas Request, *supra* note 265, at 5; Northern Request, *supra* note 258, at 23-26; United/Natural Request, *supra* note 264, at 15; INGAA Petition, *supra* note 263, at 15; AGD Request, *supra* note 258, at 12-14.

285. See, e.g., Order No. 436, *supra* note 2, at 42,427-28.

286. Supplemental Application for Rehearing of Amoco Prod. Co. (filed July 7, 1986).

287. See, e.g., KN Application, *supra* note 247, at 26-30; Northern Request, *supra* note 258, at 13-23; Natural/United Request, *supra* note 264, at 15; AGD Request, *supra* note 258, at 9-10.

288. See, e.g., AGD Request, *supra* note 258, at 13.

289. So as not to prejudice positions they may take on behalf of their clients before the Commission and the courts, the authors have not analyzed here the question of whether the issuance of Order No. 451 represents a lawful exercise of the Commission's authority. Instead, the discussion focuses on the practical impact of the order on the segments of the gas industry.

290. See generally *supra* text accompanying notes 141-167.

highly regulated to a more market-oriented industry. Producers have long engaged in fierce competition with one another, for example, in bidding for leases, and are used to this type of environment. Thus, most producers should experience little difficulty in adjusting to a competitive market atmosphere.

An important benefit of Order Nos. 436 and 451 for natural gas producers will be the broadening of their opportunities to take advantage of newly-opened gas markets. While many producers will still favor sales to pipelines in view of their load balancing abilities and multiple outlets for gas, Order Nos. 436 and 451 will provide producers with greater flexibility to accumulate a mixed portfolio of pipeline, local distribution company and end-user customers.

Older and larger producers will probably benefit more from these new competitive opportunities than newer and smaller producers. Established producers with large old gas inventories should benefit most from the new ceiling price prescribed for such gas in Order No. 451. The economies of scale enjoyed by larger producers and greater experience in marketing²⁹¹ may give these producers a competitive advantage over smaller producers that will no longer be able to rely on regulatory programs to protect the security of their prices and markets. In the new gas market, new gas and smaller producers will have to be well managed in order to compete. Indeed, many small independent producers may not survive.

Order No. 451 will create problems as well as opportunities for the producing segment of the industry. For instance, the order may have an adverse effect on the development of new gas reserves, particularly by small producers who thrived under the NGPA. Increased old gas prices should, as the Commission predicts, provide older, larger producers with an incentive to maximize the recovery of old gas. If, however, increases in old gas prices cause the price of new gas to fall, producers of new gas may have neither the incentives nor the financial resources to explore for and develop additional reserves of new gas. Such a phenomenon, were it to occur, could cause severe adverse repercussions for the entire industry in years to come.

The extent to which the good faith negotiation rule will be used by producers, at least in the near term, is uncertain. Because the rule enables purchasers to include multi-vintage contracts in the negotiation process,²⁹² producers would appear to have little reason to invoke the rule unless their contracts with a purchaser encompass primarily old gas or voluntary renegotiation fails. Pipelines also may use as a bargaining tool in the renegotiation of multi-vintage contracts the threat of shutting in high cost gas until producers accept the pipelines' terms. Further, producers may have difficulty persuading prospective new customers to negotiate seriously for gas which could be lost through the exercise of a right of first refusal by an existing firm sales customer of a non-Order No. 436 pipeline.²⁹³

The good faith negotiation rule may create other pressures on producers.

291. See, e.g., *supra* note 54.

292. Order No. 451, *supra* note 1, at 22,219 (to be codified at 18 C.F.R. § 270.201(b)(2)).

293. Unlike the right of first refusal in the Commission's regulations implementing Section 315 of the NGPA, Order No. 451 does not establish a procedure for waiver of the right of first refusal in the good faith negotiation rule. See 18 C.F.R. § 277.209 (1986).

Royalty owners of old gas interested in maximizing royalties will likely pressure producers to invoke the rule in order to increase old gas prices, although by doing so producers may open for negotiation multi-vintage contracts covering gas in which the royalty owner has no interest. In addition, producers may hesitate to market gas released by the rule to local distribution company customers of pipelines, for fear of close scrutiny of their prices by state commissions.

From the standpoint of interstate pipelines, acute problems remain in the remnants of the old regulatory structure. The Commission has drastically affected the stability of many pipelines' sales revenues by relieving pipelines' customers of their minimum commodity bill obligations²⁹⁴ and providing a means in Order No. 436 for customers unilaterally to reduce or convert to transportation their contract demands for firm sales service.²⁹⁵ Additionally, in Order No. 451, the Commission has erected the framework for an increase in old gas prices. These pressures at both ends of the pipeline will, at least in the short term, create substantial competitive difficulties for pipelines saddled with old contracts with producers calling for high gas prices and high take-or-pay obligations. While the negotiation process created in Order No. 451 has the potential to provide relief, the Commission's failure to address directly the difficulties confronting many pipelines may delay, if not prevent, some pipelines from adopting the Commission's Order No. 436 program and thus inhibit the functioning of the new gas market.

Eventually, the FERC's orders, adverse judicial decisions and competitive pressures will probably force pipelines to settle gas contract controversies with producers.²⁹⁶ When this is accomplished, the issue of how the settlements will be funded will loom large at the FERC.²⁹⁷ While regulatory battles undoubtedly will occur, it is reasonable to expect that in the end, producers, pipelines and their customers all will share in the cost of these settlements. Only after pipelines have shed these vestiges of the old regulatory system, however, will they be able to participate fully in the new, competitive gas market.

Many pipelines will have to confront the prospect of losing old gas reserves as a result of Order No. 451. Pipelines may lose markets if old gas reserves are lost through the good faith negotiation rule and new gas prices are not concomitantly renegotiated downward to accommodate this loss of lower-priced gas. The loss of revenues from sales by pipelines may be mitigated to the extent pipelines are able at least to keep old gas on their system and transport it on behalf of new customers. A very real possibility exists, however, that pipelines will lose throughput as a result of rising old gas prices, especially Order No. 436 pipelines whose customers are not granted a right of first refusal to this gas under the good faith negotiation rule.

The Commission's new competitive attitude may also lead to further con-

294. See Order No. 380, *supra* note 56.

295. See, e.g., 18 C.F.R. § 284.10 (1986).

296. See, e.g., *Court Rulings Seen As Incentive to Pipes to Settle Take-or-Pay Fights*, INSIDE FERC, Sept. 1, 1986, at 1.

297. See Tennessee Gas Pipeline Co. Order Accepting and Suspending, Subject to Refund and Conditions, Certain Revised Tariff Sheets, Rejecting Tariff Sheets, Establishing Hearing Procedures and Technical Conference and Granting Late Interventions, 36 F.E.R.C. ¶ 61,032 (1986).

centration in the natural gas industry. Over the short term, financial difficulties encountered by pipelines in adjusting to the new market may make these firms attractive takeover candidates. Over the longer term, and once contract problems have been resolved by pipelines, the prospect of having direct marketing power may tempt more large oil companies to purchase pipelines.²⁹⁸

One of the most difficult problems local distribution company customers of interstate pipelines will face as a result of Order No. 451 and the Commission's other recent regulatory changes is the abandonment or repricing of old gas reserves. While in the short term the price of old gas is expected to remain market sensitive, increases in old gas prices may eliminate the old gas cushion relied on by distribution companies before pipelines' high-cost gas problems are resolved. This phenomenon, or the loss of old gas reserves, could increase pipelines' commodity prices and engender further market erosion.

Faced with the prospect of rising gas prices, local distribution companies will have to decide whether to retain their contract demand with pipelines. Distribution companies served by more than one pipeline may be able to pressure their several suppliers to keep gas prices down by simple competitive principles. Those companies served by only one pipeline may, however, have fewer options. Overall, local distribution companies are going to have to determine whether to relinquish their firm call on gas from pipelines in exchange for packages of gas offered by producers and marketers which, while possibly more competitive as to price, cannot offer the security of supply and array of services available from pipelines. They must also insure that gas acquired from other sources will be transported by pipelines.²⁹⁹

On balance, it is likely that most local distribution companies, at least in the short term, will weigh their gas portfolios in favor of retaining their firm pipeline demand and seek more competitive sources of supply for only a portion of their market. For instance, local distribution companies may choose to retain contract demand sufficient to serve residential and commercial customers, and to "play the market" for their industrial supply. If system supply prices rise, however, the residential and small commercial customers will be the ones to suffer. Less affected will be the large industrial users which have the flexibility to swing off a local distribution company's system to other gas or fuels.

Each local distribution company will react differently based on the range of available options. For example, local distribution companies in the northeast may have great flexibility in choosing sources of supply between various pipelines and local production to serve their large commercial, residential and industrial markets. Others may be willing to assume the risk of a less stable supply in return for short-term deliveries of large quantities of low-priced gas.

Local distribution companies, of course, will continue to be subject to oversight by state public utility commissions. These commissions over time will review their purchasing practices and assess their balancing of security of supply and price. The state commissions could ultimately require local distribution

298. See, e.g., *Occidental Sets a Deal for Midcon*, N.Y. Times, Jan. 2, 1986, at 2, col. 6.

299. The Commission did not address in Order No. 451 the transportation priority of gas released under that order vis-a-vis transportation provided by pipelines under Order No. 436 and section 7 of the NGA.

companies to retain a minimum amount of firm demand from pipelines, *e.g.*, to supply captive residential and small commercial customers. The state public utility commissions will also be called upon to decide how to allocate local distribution companies' share of the cost of resolving pipelines' gas contract disputes and to fashion transportation programs for local distribution companies to complement Order No. 436 programs.³⁰⁰ This process is just beginning at the state commissions and should be completed in the next year or two.

The Commission's regulatory changes will provide large industrial customers with a variety of options in the present market. The flexibility provided those firms in selecting sources of supply will allow them to maximize their access to low-priced gas. These benefits may prove illusive, however, if market conditions change and gas shortages develop. In that event, the industrial customers may be the first to lose their gas supplies if pipelines reimpose curtailment of deliveries.

And what about the effect of the Commission's regulatory changes on consumers? In general, these changes will tie consumers more directly to the competitive forces in the marketplace. In the present-day market, that effect should be beneficial. However, if the market swings back to a period of short supply, high demand and rising prices, consumers may be adversely affected. Depending on the severity of the impact on consumers and the philosophy of a future Administration and Congress, political pressures could create the possibility of a reimposition of the type of regulation that the Commission has been moving away from in Order Nos. 436 and 451.

VI. CONCLUSION

Order No. 451 represents the final step in the Commission's continuing effort to loosen its regulatory reins over the gas industry and make it more competitive. Significant changes have been made in the Commission's regulations governing transportation, pricing and abandonment, all of which were the subject of the NOIs issued by the Commission in late 1984 and early 1985. Order Nos. 436 and 451, however, must survive judicial review. There are also numerous remnants of the old regulatory structure that need to be adjusted, and the new structure will certainly need fine tuning. Only after this is accomplished and the Commission's orders are approved by the courts, will the new gas market be able to function as envisioned by the Commission.

300. The transportation provisions of Order No. 436 do not apply to local distribution companies.