

RM91-11-000

UNITED STATES OF AMERICA 59 FERC P 61,030
FEDERAL ENERGY REGULATORY COMMISSION

[18 CFR Part 284]

Pipeline Service Obligations)	Docket No. RM91-11-000
and Revisions to Regulations)	
Governing Self-Implementing)	
Transportation Under Part 284 of)	
the Commission's Regulations)	
Regulation of Natural Gas Pipelines)	Docket No. RM87-34-065
After Partial Wellhead Decontrol)	

ORDER NO. 636

FINAL ROLE

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Regulatory Commission of Alaska
By: [Signature]
Northern Lights Realtime & Reporting, Inc.
(907) 337-2221 U-16-066

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UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Martin L. Allday, Chairman;
Charles A. Trabandt, Elizabeth Anne Moler,
Jerry J. Langdon and Branko Terzic.

Pipeline Service Obligations)	Docket No. RM91-11-000
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I. INTRODUCTION

By adopting the proposed rule with modifications, this rule requires significant alterations in the structure of interstate natural gas pipeline services in light of the changes in the natural gas industry brought about by the Natural Gas Policy Act of 1978 (NGPA), 1/ the Commission's open access transportation program, 2/ and the Natural Gas Wellhead Decontrol Act of 1989

1/ 15 U.S.C. 3301-3432 (1988).

2/ Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 436, 50 FR 42408 (Oct. 18, 1985), FERC Stats. & Regs. [Regulations Preambles 1982-1985] P 30,665
continued...)

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Decontrol Act). 3/ The Commission believes that this rule, when fully implemented, will finalize the structural changes in the Commission's regulation of the natural gas industry. This rule will therefore reflect and finally complete the evolution to competition in the natural gas industry initiated by those changes 4/ so that all natural gas suppliers, including the pipeline as merchant, will compete for gas purchasers on an equal footing. As discussed below, this promotion of competition among gas suppliers will benefit all gas consumers and the nation by "ensur[ing] an adequate and reliable supply of [clean and abundant] natural gas at the lowest reasonable price." 5/

II. PUBLIC REPORTING REQUIREMENTS

The Commission estimates the public reporting burden as a result of this rule to be an average of 4,810 hours per response

2/ (...continued)

1985), vacated and remanded, *Associated Gas Distributors v. FERC*, 824 F.2d 981 (D.C. Cir. 1987), cert. denied, 485 U.S. 1006 (1988), readopted on an interim basis, Order No. 500, 52 FR 30334 (Aug. 14, 1987), FERC Stats. & Regs. [Regulations Preambles, 1986-1990] 30,761 (1987), remanded, *American Gas Association v. FERC*, 888 F.2d 136 (D.C. Cir. 1989), readopted, Order No. 500-H, 54 FR 52344 (Dec. 21, 1989), FERC Stats. & Regs. [Regulations Preambles 1986-1990] 30,867 (1989), reh'g granted in part and denied in part, Order No. 500-I, 55 FR 6605 (Feb. 26, 1990), FERC Stats. & Regs. [Regulations Preambles 1986-1990] 30,880 (1990), aff'd in part and remanded in part, *American Gas Association v. FERC*, 912 F.2d 1496 (D.C. Cir. 1990), cert. denied, 111 S. Ct. 957 (1991).

3/ Pub L. No. 101-60, 103 Stat. 157 (1989).

4/ Those changes are discussed in detail, *infra*.

5/ S. Rep. No. 39, 101st Cong., 1st Sess., at p. 1 (1989) and H.R. Rep. No. 29, 101st Cong., 1st Sess., at p. 2 (1989).

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pipelines know how much gas is in the system, whose gas it is, and who is taking delivery of the gas. Pipelines will be allowed cost recovery for purchasing and installing such equipment in their NGA section 4 rate cases, subject to prudence reviews. As indicated above in connection with capacity curtailment, the participants should also explore the need for authorized diversion where the gas can be diverted in specific circumstances with reasonable compensation.

VIII. RATE DESIGN

A. Introduction

As part of the Commission's actions to improve the competitive structure of the natural gas industry, the Commission will adopt the proposed rule and require a generic change in pipeline transportation rates to eliminate potential competitive distortions in pipeline rate structures. Specifically, the Commission's task is to determine the appropriate level of fixed transportation and storage costs to be recovered through the reservation charge 172/ and usage charge in designing pipeline rates. 173/ This determination is known as cost

172/ Section 284.8(d) of the Commission's regulations permits pipelines to charge a reservation fee. The Commission will here refer to reservation charge rather than demand charge even when the discussion relates to the firm sales demand charge.

173/ The usage charge is also referred to as the commodity charge. However, usage is the correct term to use in connection with transportation, rather than sales, rates.

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classification and is one part of the ratemaking process described below.

The Commission engages in five steps in fashioning a pipeline's rates for its jurisdictional customers. The first task is to determine the pipeline's overall cost of service.^{174/} The second task is to functionalize the pipeline's costs by determining to which of the pipeline's various operations or facilities the costs belong. This step is known as functionalization and mainly turns on the particular characterization of the pipeline's facilities as production area, transmission, or storage facilities. The third task is to categorize the costs assigned to each function as fixed costs (which do not vary with the volume of gas transported) or variable costs, and to classify (i.e., assign) those costs to the reservation and usage charges of the pipeline's rates. This step is known as classification. The fourth task is to apportion the costs classified to the reservation and usage charges among the pipeline's various rate zones and among the pipeline's various classes of jurisdictional services. This step is known as allocation. The fifth task is to design each service's rates for billing purposes by computing unit rates for each service. This step is known as rate design. The entire process is known as ratemaking.

174/ The pipeline's cost of service is the total revenues needed to cover the pipeline's operations, including a just and reasonable return on its rate base.

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The instant rule will not address functionalization, which is mainly important in determining whether facilities are jurisdictional or nonjurisdictional. 175/ The Commission will continue to functionalize between transportation and gathering based on the modified Farmland test. 176/ The present focus is on classification as it relates to allocation and to the designing of the actual rates.

B. Background

The Commission uses the cost classification aspect of the ratemaking process to achieve policy goals that are pertinent to current conditions. Because conditions change over time, the Commission's goals change and the weight given to various goals also changes. This balancing of goals is a matter of judgement and is not an exact science. 177/

Frequently, however, the Commission has emphasized one particular goal in its ratemaking. That goal is to design pipeline rates in light of competition. This has involved the shifting of costs from the commodity to the reservation charge to keep pipeline rates competitive. For example, in 1965, the Commission approved rates that put ninety-six percent of a

175/ See, e.g., Trunkline Gas Co. 58 FERC P 61,240 (1992) and Interstate Natural Gas Pipeline Rate Design, 56 FERC 61,086 (1991).

176/ Farmland Industries, Inc., 23 FERC P 61,063 (1983) and Amerada Hess Corp., et al., 52 FERC P 61,268 (1990).

177/ Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 589 (1945) ("Allocation of costs is not a matter for the slide-rule. It involves judgement on a myriad of facts.")

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pipeline's fixed costs in its reservation charge to take into account competition from coal. 178/ After the curtailment era, in 1983, the Commission first adopted the modified fixed variable (MFV) method in recognition of the annual underutilization of pipeline facilities. 179/ MFV also was devised to help pipelines sell gas by moving all fixed costs except for return on equity and related taxes to the reservation charge. 180/ In almost all cases, MFV reduced the pipeline's fixed costs included in its commodity charge compared to the fixed costs included in the commodity charge under the previously used Seaboard 181/ or United methods. 182/ MFV, therefore, was adopted in pursuit of the goal of competition by

178/ E.g., *Fuels Research Council, Inc. v. FPC*, 374 F.2d 842 (7th Cir. 1967) (The court affirmed the Commission's deviation from the Seaboard (see *infra*) method by putting 96 percent of fixed costs in the demand charge over the objection of coal associations.).

179/ *Natural Gas Pipeline Company of America*, 25 FERC P 61,176 (1983), order on reh'g, 26 FERC P 61,203 (1984), aff'd in relevant part, *Northern Indiana Public Service Co. v. FERC*, 782 F.2d 730 (7th Cir. 1986).

180/ Future references to fixed costs are to fixed transmission and storage costs. Storage will be unbundled from transportation and separately charged. However, some storage may be retained by the pipeline for its balancing and system management operations associated with transportation and for its no-notice transportation service.

181/ *Atlantic Seaboard Corp.*, 11 FPC 43 (1952) (Fifty percent of fixed costs recovered in the commodity charge).

182/ *United Gas Pipe Line Co.*, 50 FPC 1348 (1973), aff'd sub nom., *Consolidated Gas Supply Corp. v. FPC*, 520 F.2d 1176 (D.C. Cir. 1975) (Seventy-five percent of fixed costs recovered in the commodity charge).

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lowering pipeline sales commodity charges to enable gas to compete effectively with alternative fuels such as oil.

The Commission again emphasized the need for competitive rates when it adopted Order No. 436. 183/ Section 284.7(c) of the Commission's regulations, promulgated by Order No. 436, sets forth the Commission's rate objectives in designing maximum rates for both peak and offpeak periods. In addition to rationing capacity during peak periods, 184/ Section 284.7 states that "rates for firm service during off-peak periods and for interruptible service during all periods should maximize throughput." 185/ In addition, Section 284.7(d) (5) authorized pipelines to discount their transportation rates below the maximum rate in order to adjust the price to meet competition from competitive fuels and from other pipelines. 186/

The Rate Design Policy Statement, while emphasizing the possible need to ration capacity, also recognized the importance of maximizing throughput in its discussions of discounted rates and rates for interruptible transportation service. In Panhandle Eastern Pipe Line Co., Opinion No. 369, 187/ the Commission refined its approach to the rationing capacity and maximizing

183/ See n.2, supra.

184/ "Rates for service during peak periods should ration capacity." 18 CFR 284.7(c) (1).

185/ 18 CFR 284.7(c) (2).

186/ Order No. 436, supra n.2, at pp. 31,543-545.

187/ 57 FERC P 61,264 (1991).

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throughput goals by retaining MFV for cost allocation purposes because there was no need to ration capacity on Panhandle's system, 188/ but adopted the straight fixed variable (SFV) for rate design (billing) purposes because of the need to put all fixed costs in the demand charge to maximize Panhandle's throughput. 189/

C. Discussion

The Commission has discussed above in detail the evolution of the natural gas industry from a regulated, interstate, sales for resale industry with LDCs purchasing gas at the city gate to a decontrolled gas market with gas sold in the production area and transported to the city-gate under Part 284 open access transportation. 190/ The Commission is here adopting regulations to ensure that all gas supplies are moved to market on even terms. The Commission is adopting these regulations in order to promote competition among gas sellers (including the pipelines as merchants) in a now national gas market to ensure consumers access to adequate supplies of clean and abundant gas at reasonable prices. The Commission's task is to analyze cost classification, in light of the goals discussed in this order. The appropriate cost classification method used to allocate costs

188/ Id. at p. 61,843.

189/ Id. at p. 61,827-30.

190/ In 1990, transportation amounted to 79 percent of the total gas delivered for market by pipelines. INGAA November 1991 paper, supra, Table A-1.

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and design rates should in no way inhibit the creation of a national gas market of efficient gas merchants as envisioned by Congress in enacting the Decontrol Act. Ratemaking, like transportation terms and conditions, should comport with the goal that all gas should be shipped on even terms. 191/

The first question is whether the pipelines' currently effective cost classification methods will inhibit the goal of the development of a competitive, national gas market and, therefore, do not comport with the goals set forth in this order or with Congress' goals in enacting the Decontrol Act. In particular, the inquiry is whether the pipelines' current methods distort the gas purchaser's decision because the transportation usage charges vary in the amount of fixed costs included in each pipeline's transportation usage charge. Because the currently effective cost classification method used by most pipelines is MFV, this order will discuss the instant issue with reference to MFV. However, the following discussion and conclusion about MFV applies equally to other methods that recover fixed costs in the usage charge.

Pipelines have differing amounts of fixed costs in their usage charges because those fixed costs (return on equity and related income taxes) are determined by reference to revenue

191/ At times, the issue has been framed in the context of competition between Canadian and domestic gas. See Opinion No. 357, Iroquois Gas Transmission System, L.P., et al., 53 FERC P 61,194 at pp. 61,712 n.91 (1990) and Tennessee Gas Pipeline Co., 51 FERC P 61,113 (1990) (NIPPS II).

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requirement criteria that differ on each pipeline. The portion of the revenue requirement for the return on equity depends on the size of a pipeline's rate base, the pipeline's ratio of equity to total capital, and the allowed rate of return on equity. Because pipelines have rate bases that vary according to their original costs and how much they have been depreciated, and because pipelines have different capital structures and allowed rates of return on equity, the pipelines have different amounts of fixed costs in their usage charges under MFV. 192/ Moreover, MFV could bias the debt-equity ratio because pipelines can increase their debt component to lower their usage charges for competitive reasons.

This situation of differing levels of fixed costs in pipeline usage charges can hinder competition between gas sellers at the wellhead because competition is not based on the seller's costs and therefore on their ability to compete directly with each other. Rather, competition for sales customers is influenced by the fixed costs in the pipeline transportation usage charges. For example, producers in different fields that compete for market share via different pipelines will often have their competitive positions in that market affected by the amount of fixed costs in the pipelines' respective transportation usage charges and not by the producers' own costs and efficiencies in producing gas. The MFV cost classification method results in the

192/ The more equity a pipeline has in its capital structure, the more return and related taxes will be in the usage charge.

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shipment of gas on uneven, rather than on even, terms and will inhibit the development of a national market which "will yield lower prices and more abundant supplies" by "over time forc[ing] the evolution of a set of lowest-cost producers" as envisioned by Congress in decontrolling the price of gas at the wellhead and in the field. 193/ Accordingly, unless the Commission permits otherwise, as described below, the Commission concludes that MFV is not in the public interest, unreasonably hinders competition among gas sellers, and is unjust and unreasonable under NGA Section 5.

The Commission here is addressing cost classification for both cost allocation and rate design (billing) purposes. This means that the Rate Design Policy Statement no longer will be applicable to apportioning costs to the reservation and usage charges. However, the Rate Design Policy Statement still will be applicable to other matters, such as the determination of rates for interruptible transportation, the discounting of rates, and the requirement that rates "reasonably reflect any material variation in the cost of providing the service due to ... [t]he distance over which the transportation is provided." 194/

Specifically, the Commission is amending Section 284.8(d) of the regulations to require pipelines to recover their transportation costs under the straight fixed variable (SFV)

193/ H.R. Rep. No. 29, supra, at p. 7.

194/ 18 CFR 284.7(d)(3).

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method of assigning all fixed costs related to transportation to the reservation charge. The Commission, however, will not rigidly preclude the pipeline, its customers, and interested state commissions, producers, marketers, brokers, end-users, and others from agreeing to an alternative method that deviates from SFV and may be appropriate to that particular pipeline system. If the parties affected by a pipeline's rate design agree to a different method, the Commission will consider giving effect to the parties' agreement. However, to the extent a pipeline's rates deviate from SFV, the Commission will carefully consider the arguments of those parties^{195/} proposing the deviation as well as the parties opposing the deviation. Thus, while a single party cannot preclude the Commission from considering a deviation from SFV, any party (or parties) advocating something other than SFV carries a heavy burden of persuasion. The language in section 284.8(d) of the regulatory text implements this approach and ensures that the Commission will ultimately resolve this issue.

The Commission believes that requiring SFV comports with and promotes Congress' goal of a national gas market as discussed above and goes hand-in-hand with the equality principle. Under SFV, all gas merchants would be able to compete in a national market without regard to fixed transportation costs included in

195/ Parties include, among others, pipelines, producers, marketers, brokers, LDCs, state commissions and agencies, and end-users, such as industrials and gas-fired electric generators.

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the usage charge. 196/ This approach is as essential to the shipment of gas on even terms as is equality in the quality of service with respect to gas transportation. SFV would, therefore, maximize the benefits of wellhead decontrol by increasing the nationwide competition among gas merchants (including pipelines). This should result in head-to-head, gas-on-gas competition where the firm transportation rate structure is not a potentially distorting factor in the competition among merchants for gas purchasers at the wellhead and in the field. This merchant-to-merchant competition should help to achieve Congress' intent in passing the Decontrol Act to "over time force the evolution of a set of lowest-cost producers." 197/ This "will yield lower prices and more abundant supplies" and benefit all consumers of gas. 198/

Moreover, the Commission's adoption of SFV should maximize pipeline throughput over time by allowing gas to compete with alternate fuels on a timely basis as the prices of alternate fuels change. The Commission believes it is beyond doubt that it is in the national interest to promote the use of clean and

196/ Only a small amount of variable costs (such as fuel) would be in the firm transportation usage charge. Interruptible transportation rates will continue to be determined on a case-by-case basis under the Rate Design Policy Statement. With unbundling, the role of interruptible transportation should be diminished.

197/ H.R. Rep. No. 29, *supra*, at p. 7.

198/ *Id.*

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abundant natural gas over alternate fuels such as foreign oil. 199/ SFV is the best method for doing that. As discussed above, using cost classification to design rates to influence the consumption of gas is a traditional regulatory technique of the Commission. For example, the Commission has removed costs from the commodity charge to enable pipelines to meet competition for fuel switching customers from coal. 200/ And, indeed, the Commission adopted MFV in the context of competition from oil. The Commission finds it appropriate to use that technique again in the current circumstances.

D. Comments on the NOPR's Proposal

The NOPR proposed to adopt SFV for cost allocation and rate design. A few commenters support the NOPR's proposal to mandate the use of SFV generically. 201/ More commenters support SFV as a method to be implemented on a case-by-case basis. 202/

199/ S.R. Rep. No. 39, supra, at p. 2 and H.R. Rep. No. 29, supra, at p. 2.

200/ See, e.g., the discussion of gas versus coal competition in *Fuels Research Council, Inc. v. FPC*, 374 F.2d 842 (7th Cir. 1967).

201/ E.g., Independent Petroleum Association of Mountain States, Colorado Oil and Gas Association, Independent Petroleum Association of New Mexico and Wyoming Independent Producers Association, Panhandle Eastern Pipeline Group (in most instances), and IPAA (presumption).

202/ E.g., Natural Gas Supply Association/Indicated Producers and INGAA. The Department of Energy generally endorses the use of straight fixed variable but asks the Commission to "make it clear other rate designs will be approved on a case-by-case basis." Initial Comments at 3.

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A number of LDCs and state commissions oppose SFV. 203/ Their objections fall into two categories. They first argue that the Commission has not established that MFV is anticompetitive. In that vein, they argue that gas purchasers base their gas purchasing decisions on total costs and not only on incremental costs as assumed by the Commission. They also argue that SFV conflicts with other rate design goals. In that vein, they question the impact of SFV on pipeline incentives to enhance service reliability, maintain or maximize throughput, for example, in pipeline-to-pipeline competition, and control costs and the construction of facilities. In addition, they express concerns about the shifting of costs to low load factor customers and about the possibility that LDCs will be forced to reduce their contract demand levels and their ability to reliably serve their customers.

E. Discussion of Comments

1. Mitigation of Cost Shifts

As stated above, commenters express concerns about the shifting of costs to low load factor customers and about the possibility that LDCs will be forced to reduce their contract demand levels and their ability to reliably serve their customers. The Rate Design Policy Statement recognized the possible need for pragmatic adjustments in the event a particular

203/ E.g., Distributors Advocating Regulatory Reform, Public Service Commission of the State of New York, Brooklyn Union Gas Company, Baltimore Gas and Electric Company, and Wisconsin Public Service Commission.

