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ALVIN BACA*

FERC & ERA: Issues in Natural Gas Regulation

INTRODUCTION

The natural gas industry, as all of us know, has for the last three years been involved in revolutionary change and restructuring. As producers, we have watched from the side-lines as producer-pipeline-marketing relationships have been transformed, as contracts we have banked on have been torn to shreds, and as our traditional markets evaporate in the face of competition from foreign sources of gas or from fuel oil. Producers have been given various reasons for the radical changes, the most common of which is that with the deregulation of natural gas, the market itself is the cause of this fundamental change. What we call the market is not alone responsible. Two federal agencies—the Federal Energy Regulatory Commission [FERC] and the Economic Regulatory Administration [ERA]—are jointly responsible for much of the ongoing radical restructuring and distress in the natural gas industry.

ECONOMIC REGULATORY ADMINISTRATION

Responsibility and Jurisdiction

The ERA¹ is the federal agency whose responsibility is to authorize imports of natural gas under Section 3 of the Natural Gas Act.² The ERA also develops import policy and a trade framework for imported natural gas. The ERA is an agency of the U.S. Department of Energy [DOE], from which it takes much of its direction.

Import Criteria

The published policy objectives and criteria used by the ERA for approving imports are: (1) competitive import arrangements are in the public

*Development of this chapter was the result of a joint effort by the author, Bob Platt and George Yates.

1. Created by the 1977 DOE Organization Act, 42 U.S.C. § 7136 (1982).

2. 15 U.S.C. § 717(b) (1982). Prior to enactment of the DOE Organization Act, all Section 3 authority vested in the Federal Power Commission. From 1978 to 1984, Section 3 was authority shared by the FERC and ERA. See Huard, *Regulation of the Importation and Exportation of Natural Gas: A Survey and Analysis of Section 3 of the Natural Gas Act*, 15 J. INT'L L. & ECON. 533 (1981). On Feb. 22, 1984, the Secretary of Energy rescinded all of the FERC's Section 3 authority. 49 Fed. Reg. 6684 (1984).

interest; (2) market-responsive, freely negotiated contracts lead to competitive arrangements; and (3) U.S. and imported gas should have equal access to U.S. markets.³

Under the direction of Secretary of Energy Hodel and continued under Secretary Herrington, the de facto policy of the ERA has been to introduce large volumes of imported gas to displace markets previously served by domestic gas, to reduce the burner tip price of natural gas, and, correspondingly, the domestic wellhead price.

Recent Rulings

In the last four years the ERA has approved import applications which, if added to previous licenses, would result in the approval of a sufficient volume of imported gas to displace fifteen percent of the domestic market.⁴

The wholesale approval of import licenses began in February 1984 when Secretary Hodel, overcoming what he called "non-competitive forces," negotiated with the Canadian government to end government regulation of border prices. This drastically reduced the price of imported gas from Canada.⁵ About the same time, PG&E, the large California local distribution company (and majority owner of the Canadian distribution system, Pacific Gas Transmission [PGT], which supplies PG&E,⁶ and also the owner of a large Canadian supplier of gas to PGT, Alberta & Southern) persuaded the Canadians that they were losing market share in the United States. As a result, the Canadian government devised their two-part rate reform system which, while preserving high prices for the bulk of imported gas, effectively undercut El Paso's delivered supplies by selling incremental volumes at substantially discounted prices.

I don't wish to leave the impression that I oppose imports or arm's-length competition with non-domestic suppliers. I do not. I am against the federal government's granting, through an administrative agency, advantages to foreign suppliers which domestic producers do not enjoy. In issuing several large import licenses, the ERA did just that. PG&E has license to import Canadian gas through their Canadian subsidiary, Pacific Gas Transmission, under long-term contract from their wholly

3. New Policy Guidelines and Delegations Orders from Secretary of Energy, 49 Fed. Reg. 6684 (1984). The PPROA contends that these "guidelines" were promulgated in violation of § 404 of the DOE Organization Act, 42 U.S.C. § 7174, because they were not referred to the FERC for review. The D.C. Circuit has this matter pending before it. *PPRO v. ERA*, No. 86-1058 (D.C. Cir. 1987).

4. As of May 1987, the volume of "blanket" ERA import authorizations exceed 14.8 tcf of gas. Domestic annual production is approximately 16 tcf per year.

5. In many cases, the change in policy did not drastically reduce the cost per unit of imported natural gas. The Canadians restructured their rates into a two-part rate form. For example, if you rent a car for \$20 per day and 5 cents per mile, is it less expensive than a car renting for \$50 per day and 1 cent per mile? The answer depends on how many miles you drive.

6. PG&E is the California distributor. PGT is the pipeline.

owned Canadian production company, Alberta & Southern, on a preferred basis. The preference is the result not only of the ERA's license process, but FERC Order 380⁷ which granted rate-treatment preferences to Canadian subsidiaries of the California LDC's over domestic pipelines. I will cover Order 380 in more detail later in this article.

What are the cumulative results of the ERA's import policy? Canadian imports compete not only with short-term spot market sales but with system supply gas. Ironically, much domestic system supply gas has been forced into the spot market through pipeline contract abrogation⁸ or through pipeline exercise of contract market-out clauses. The low priced gas is primarily American.

FEDERAL ENERGY REGULATORY COMMISSION

Historical Perspective

The FERC is the successor body to the Federal Power Commission (FPC) and is charged with rather broad regulatory authorities under the Natural Gas Act of 1938⁹ (as interpreted by the courts) and the Natural Gas Policy Act of 1978¹⁰ for the regulation of the transportation and sale of natural gas. In addition, the FERC regulates the resale rates and facilities for imported gas.¹¹

The FERC is made up of politically appointed Commissioners, and is thus subject to changes in political perspectives on natural gas. The FPC was dominated by consumerists (in the narrow sense) and price controllers until the natural gas shortages of the mid-seventies. During the Reagan administration, rather than involving itself in setting "just and reasonable" rates¹² for natural gas, the FERC has been actively reshaping the structure of the natural gas industry.

Ratemaking Basics

A primary responsibility of the FERC has been setting the rates that interstate pipelines can charge their customers for jurisdictional sales. Gas sold to an interstate pipeline by a producer or an affiliate and resold to a regulated local distribution company [LDC] is a jurisdictional sale

7. Elimination of Variable Costs from Certain Natural Gas Pipeline Minimum Commodity Bill Provisions, 49 Fed. Reg. 22778 (1984). *Wisconsin Gas Co. v. FERC*, No. 84-1358 (D.C. Cir. Aug. 20, 1985) followed the pipeline commodity provisions.

8. *See, e.g., Tennessee Gas Pipeline Company v. Pan-Canadian Petroleum Co.*, 37 FERC 61,236 (1986), *rehearing denied*, 38 FERC 61,236 (1987).

9. 15 U.S.C. §§ 717-717(w) (1982).

10. 15 U.S.C. §§ 3301-3342 (1982).

11. 15 U.S.C. §§ 4, 5, 7, 717(c), (d), and (f). *See generally, Wisconsin Gas*.

12. 15 U.S.C. § 717(c).

and prices are controlled by the FERC.¹³ This kind of gas sale was the traditional market for gas producers until the spot sale programs began recently. Comments about ratemaking concern this type of sale. The sale of gas to an end user that is not a regulated LDC is not a jurisdictional sale but is still certificated.¹⁴ Transportation of gas not purchased for resale should be considered separately from the normal rate setting process.

For regulatory purposes, pipeline costs are classified into fixed and variable costs known as "demand" and "commodity" charges. If you rent a car, it is common to pay a per-day rate, say \$50. This is a demand charge which gives you the right to use the car during the rental period. You also might pay a mileage rate, say \$.10 a mile. This would be your commodity rate. By altering the fixed and variable rates,¹⁵ car rental companies can enhance or detract from the marketability of their automobiles. The FERC does somewhat the same thing by altering the fixed costs includable in commodity charges. In this way the FERC attempts to satisfy low or high volume customers. To avoid complicating this discussion further, I will now leave commodity and demand charges. This concept is very important in understanding how the FERC has changed our gas market and will be discussed later.

To understand the market and its participants, we share the premise that during a period of supply abundance, there is a finite charge that consumers will pay for natural gas. That market price per mcf has to be divided among producers, pipelines, and LDCs. The price that producers have been receiving during this period of market contraction has been, with FERC's approval, whatever is left over after the interstate pipelines and LDCs have taken their fees off the top.

There are three important generalizations which help us understand interstate pipelines (and they are almost always true): (1) they pay no taxes (they are guaranteed an after-tax rate of return);¹⁶ (2) they litigate free, even when suing customers (this is a great device to be used in conjunction with breaking contracts because pipelines can wear down their opponents through the litigation process, and their customers pay for it all); (3) pipelines are never at risk in a regulated transaction. They

13. Any "sale for resale in interstate commerce" is subject to the FERC's Natural Gas Act jurisdiction, except for certain "first sales" removed by operation of Section 601(a)(1) of the NGPA.

14. The transportation is either certified under § 7(c) of the Natural Gas Act, or authorized under § 311(a) of the NGPA. See, *FPC v. Transcontinental Gas*, 365 U.S. 1 (1961).

15. Pipeline rates are set based upon recovering a statutory tax rate, regardless of the actual tax rate paid by the corporation. To earn its after tax allowed return, it must meet its "billing determinate" sales and transportation levels. By setting such targets too low and tax rates too high, pipelines virtually allow earn returns far in excess of the return figures used to construct their rates.

16. *Associated Gas Distributors v. FERC*, No. 85-1811 (D.C. Cir. June 23, 1987).

are theoretically at risk, but the regulatory system has, in fact, always bailed them out.

Put simply, profit to a pipeline is calculated as a rate of return of invested capital (referred to as a "rate base"), meaning that the more that a pipeline invests, the larger the return. A regulated pipeline, therefore, has little incentive to moderate capital costs as do other businesses.

A device commonly used by the interstate pipelines is to coerce its customers into higher rates under the FERC process. When a pipeline applies for a rate increase, it is effective for five months before it can be challenged. This often results in settlement at rates higher than would normally be approved.

An interstate pipeline, in addition to its approved return, has two additional significant sources of income: (1) underestimating throughput and (2) overstating costs. During a rate hearing here is an overwhelming temptation to underestimate the volume of gas to be sold by that pipeline before the next rate hearing. Since a pipeline rate includes reimbursement for fixed costs on an mcf basis, the lower the estimated volume, the higher the transportation rate per unit sold. Should a pipeline underestimate the volume sold, an accident which predictably happens, the Commission does not correspondingly reduce the transportation rate approved for the next period. Under current FERC rules such retroactivity is prohibited.

The result of our ratemaking system? The interstate pipelines, during a period of acute economic distress to producers, have been able to achieve higher returns while selling smaller volumes. For example, pipeline margins from 1981 to 1984 increased from an average of \$1.17 to \$1.64 per thousand cubic feet [mcf]. Most businesses make more by selling more, and while this may be the case for the pipelines someday, it is not yet. While some end users and most producer prices are subject to competitive market forces, pipeline costs during this period inflated to fill the vacuum created by wellhead prices controlled either by government or constrained by pipeline activities. The percent return approved by the FERC is an after-tax percentage which, for the last several years has averaged around fifteen percent. Based on a recent estimate by the AGA, this figure declined to about 12.5 percent in 1985. These returns, of course, imply a pre-tax return of twenty percent or more, risk free.

Something is obviously wrong with a regulatory system that allows utilities guaranteed returns of this magnitude while the nonregulated segment of the same industry bleeds to death.

Order 380: Beginning of a Painful Transition

In the summer of 1980 the FERC turned the somewhat level playing

field on its end, with producers, El Paso Natural Gas and Transwestern at the bottom, and with Southern California Gas and PG&E at the top.

Recall the above discussion of demand and commodity rates. The FERC, in Order 380, denied interstate pipelines the right to include variable costs in any negotiated minimum bill obligations (the pipeline equivalent of take-or-pay) thereby relieving SOCAL and PG&E of a substantial penalty for not taking gas from El Paso and Transwestern. When LDC's have no minimum bill, they can swing from contracted (system supply) gas to other sources of gas supply. The gas that PG&E and SOCAL chose to swing to was Canadian gas—through their subsidiaries—and spot market gas.

You might reasonably ask why PG&E and SOCAL were allowed to substitute Canadian gas (their own gas in some cases—remember Alberta & Southern) for domestic contracted gas. The answer is that the Canadian distribution companies owned by PG&E & SOCAL were granted exemption from Order 380 so that they can pass minimum bill obligations onto California LDC's. Under the California Public Utilities Commission's (CPUC) "Least Cost Rule," average costs of Canadian gas, including demand charges, are not compared to average costs of domestic supplies; only variable costs are considered. The Canadian gas is allowed the exclusive privilege to carry a demand charge which not only causes that gas to be overpriced compared to domestic supplies, but the existence of the demand charge is a guarantee that Canadian gas will flow while domestic gas is shut-in.

Of interest to any student of FERC is the method by which Pacific Gas Transmission, subsidiary of PG&E, and Pacific Interstate Transmission (PIT), a subsidiary of SOCAL, were exempted from Order 380. The FERC preferred an oblique rather than a direct exemption for the California LDC's. The Commission, therefore, exempted any LDC involved in the unsuccessful Alaska Natural Gas transmission system. Conveniently, both subsidiaries were involved. We were playing against a stacked deck.

The blatant conflict of interest shared by the California LDCs has been used to manipulate the California market. The temptations have been overwhelming. A Mae West quote describes their behavior: "I generally avoid temptation unless I can't resist it."

Based on the propensity of interstate pipelines to disregard contracts with producers, Order 380 could be regarded as poetic justice, except that it became an excuse for more contract abrogation. Order 380 and the later elimination of the commodity minimum bills were the father of the current spot market. Without variable costs in the minimum bill there was no incentive to continue existing contractual, supply relationships. In addition, sellers were pressured by pipelines to convert contracted gas

to spot market gas. The spot market exploded. What was meant to be a measure to enhance market discipline was, in fact, direct and unwarranted intrusion by a regulatory body into commercial contractual agreements. Rather than market discipline, chaos resulted, with, once again, the producer losing. This ushered in the present environment of gas-on-gas as well as gas-on-fuel oil competition as market discipline evaporated.

Order 451: End of Price Vintaging

FERC Order 451 was the result of a recommendation by the DOE that the FERC establish a ceiling price for all price-controlled gas which would be high enough, in effect, to eliminate price vintaging. Order 451 established a ceiling price of \$2.57 per mmbtu which is, as we know, above the current market price for new natural gas. As the critics of 451 have maintained, this would effectively end federal price controls on natural gas. It would indeed, except for the details. Collection of a higher price under this Order is dependent upon a very complicated process called a "good faith negotiation procedure" where producer contracts, other than the one the producer might wish to improve, are opened up for negotiation. This procedure carries severe risks for the unwary producer, and for that reason, I don't think it will be used extensively.

Order 436: Nondiscriminatory Transportation

FERC Order 436 establishing "voluntary nondiscriminatory transportation" is an attempt by FERC to reform the interstate natural gas transportation system. Even though the Order did not immediately convert interstate pipelines from merchants to transporters, it has dramatically speeded up that process.

This order allows each interstate pipeline to voluntarily choose to transport natural gas for third-parties if a written request is received from a shipper. If a pipeline chooses to be a voluntary transporter, that pipeline must discontinue existing transportation arrangements, including gas transported for affiliates. Based on this definition of "voluntarism" almost all interstate pipelines have or will agree to be 436 carriers. The FERC, however, has allowed the process to slide. Many applications of 436 are waiting for FERC approval on a case-by-case basis which involves the danger of special deals which may not benefit the producer.

A major condition to 436 transportation, one especially affecting independent producers, is "available pipeline capacity." Because several months were allowed for each pipeline to choose 436 status, pipelines had the opportunity to reserve noninterruptible pipeline capacity for their existing customers [LDC's], pipeline affiliates, and major transporters. Other potential gas transporters have, in cases, been allowed transportation only on an interruptible basis. Unfortunately—and surprisingly—

the transportation rates for firm as well as interruptible sales seem to be identical. Order 436, therefore, gives even more advantage to interstate pipelines, LDC's, and pipeline affiliates. It may well be that the only way independents can serve their traditional customers is through pipelines' marketing affiliates. If there is an advantage to the average independent, it will probably be evolutionary.

Canadian producers have commissioned the FERC for inclusion of Canadian gas as a beneficiary under Order 436. I expect their request to be granted.

Order 436 has been challenged in court by major interstate pipelines, and that case is now being heard by the D.C. Circuit Court.¹⁷ It is certainly possible that portions of Order 436 will be overturned.

Ending Discriminatory "Affiliate" Practices

In late September of last year, the FERC announced efforts to end discrimination by interstate pipelines in favor of production affiliates. In the words of Commissioner Chuck Trabandt, FERC would address "a practice in which pipelines had been engaging with relative caprice for 50 years." Complaints that pipelines have continued to honor contracts with affiliates, including full take-or-pay, while refusing to honor contracts of producers, have reached the ears of the FERC. This kind of discrimination is prohibited by the NGPA. Currently, Commissioner Trabandt and Commissioner Mike Naeve are debating solutions. Trabandt suggests a standard rate-test to determine if discrimination exists, while Naeve wants the FERC to address the issue on a case-by-case basis.

Meanwhile, in a very significant case, the FERC has agreed to consider a complaint made by the Independent Petroleum Association of the Mountain States [IPAMS] against Panhandle Eastern and Colorado Interstate Gas with transportation requests by both pipelines. IPAMS charges that these pipelines transported gas in a discriminatory manner favoring pipeline affiliates to maintain monopoly positions.¹⁸ The enthusiasm with which FERC is approaching this newly discovered issue is very significant.

CONCLUSION

The federal government, through the FERC and ERA, has radically transformed the domestic natural gas industry. That transformation continues. The industry that emerges after this transition will be only a distant relative of the industry we knew and understood.

17. Initial decision found violations. Independent Petroleum Association of the Mountain States v. Panhandle Eastern, 38 FERC 63,009 (1987).