UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Notice of Inquiry Concerning Natural Gas Pipeline Negotiated Rate Policies and Practices	**))**	**Docket No. PL02-6-000**

COMMENTS OF THE NATURAL GAS SUPPLY ASSOCIATION

The Natural Gas Supply Association ("NGSA") submits these comments on the Notice of Inquiry in this proceeding on negotiated rates. As discussed below, NGSA does not oppose continuation of the negotiated rate program. This program has allowed pipelines and shippers the flexibility needed to structure rates in a manner that bests suits their needs. However, based on the actual operation of the negotiated rate program over the past several years, the Commission should revise the program to ensure that it better fulfills the Commission's objectives and better ensures continued customer confidence in negotiated rate transactions. Here are NGSA's recommendations:

1) The Commission should re-affirm that a pipeline cannot require that bids for capacity be in the form of a negotiated rate (section 1 of NGSA response to Question B, below).

2) The Commission must ensure that a pipeline's recourse rates continue to be just and reasonable, and that the recourse rates remain a viable alternative to a negotiated rate (section 2 of response to Question B).

3) The Commission should continue its policy of maintaining a clear demarcation between a negotiated rate and a negotiated service condition. The Commission should continue to prohibit negotiated service conditions (section 3 of response to Question B).

4) The Commission should re-affirm that a negotiated rate cannot be reflected in a pipeline's discount adjustment (section 4 of response to Question B).

5) To ensure effective monitoring of the negotiated rate practices of pipelines, the Commission should require a pipeline to file both the negotiated rate contract and a tariff sheet that fully describes the contract. For long-term transactions (one

year or longer), the filing should be made by the later of 30 days before implementation of the transaction or three days after the transaction is consummated. If a short-term transaction is consummated more than 30 days before implementation, the pipeline should make its filing by the later of 30 days before implementation or three days after consummation. For short-term transactions, the Commission should retain the right to suspend the rate and to require refunds if the Commission finds that the rate is excessive or otherwise improper (response to Question C).

6) If the Commission decides to allow negotiated rates that are based on gas index prices (referred to here as index rates), the following conditions should be imposed to reduce the risk that the pipeline could exercise market power in a manner that would be inconsistent with free and open, competitive natural gas markets:

   a) the pipeline must post the transactions on its electronic bulletin board as soon as an agreement in principle is reached between the pipeline and the shipper;
   b) once the transaction is posted, the pipeline must allow competitive bids from other parties for all or a portion of the capacity, and
   c) the pipeline must sell as interruptible service all unused capacity, including currently subscribed capacity that is not being utilized for firm service, at any price in excess of variable costs that clears the market, up to the recourse rate, on a continuous basis at every scheduling opportunity (response to Question F).

Question A: Has the negotiated rate program been generally successful or unsuccessful in granting pipelines needed flexibility to serve natural gas markets and retain existing markets? Please support position taken with concrete specifics as much as possible.

The Commission created the negotiated rate program to allow a pipeline and shipper to arrange "flexible, efficient pricing when market-based rates are not appropriate."[1] Since the inception of this program, shippers, such as producers and marketers, have used negotiated rates in some instances to allow deviation from the straight fixed-variable rate structure or to secure a fixed rate transportation rates to reduce financial risks, such as by locking-in a margin. A senior executive at a major pipeline

[1] "Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines and Regulation of Negotiated Transportation Services of Natural Gas Pipeline" (referred to here as the Alternative Rate Policy Statement), 74 FERC ¶61,076, *reh'g and clarification denied*, 75 FERC ¶61,024, *reh'g denied*, 75 FERC ¶61,066 (1996), *petition for review denied sub nom. Burlington Resources Oil & Gas Co. v. FERC*,

company explained:

> The most prevalent type of deal likely to occur under a negotiated rate system is the basic independent-power-producer (IPP) model, wherein the shipper can make the economics of a project work, based on the pipeline's current rates, but cannot run the risk that a reallocation of cost or simply an increase in unit costs on the pipeline will make service get much more expensive in the future. Thus, this shipper is quite willing to pay a premium, or agree to a fixed rate formula that may well exceed maximum tariff rates from time to time over the life of the contract, simply to gain rate certainty. Slowly but surely, this model is growing beyond the IPP market. It is becoming available to anyone who has a way to lock in the economics of a deal (for instance, through the futures markets, where commodity prices drive the value of transportation).[2]

However, a negotiated rate is the not the only way to establish creative rates. Generally, a pipeline has the ability to establish creative rate mechanisms in its tariff so that those mechanisms are available to all shippers. For example, most offshore pipelines have an alternative firm transportation rate schedule to accommodate the fluctuations in offshore production. These rate schedules typically require the producer to agree to commit a certain portion of its reserves for delivery by the pipeline. In return, the shipper pays a volumetric rate, and the shipper's MDQ is adjusted each month based on actual production over a prior period.[3] Thus, creative rate structures can be developed within the pipeline's tariff rather than through negotiated rate deals.

<u>Question B</u>: <u>Should the Commission modify its negotiated rate program?</u>

As discussed below, the Commission should modify certain aspects of the negotiated rate program, and re-affirm several of its current policies:

Nos. 96-1160, *et al.*, U.S. App. Lexis 20697 (D.C. Cir. July 20, 1998).

[2] Richard Smead, "Natural Gas", May 1996, p. p. 28 (John Wiley & Sons). Mr. Smead is a vice-president at El Paso Corporation.

[3] *See* High Island Offshore System tariff, Rate Schedule FT-2, First Revised Sheet No. 26; Garden Banks Gas Pipeline, LLC, 78 FERC ¶61,066, p. 61,237 (1997)(Rate Schedule FT-2); *Stingray Pipeline Co.*, 86 FERC ¶61,320, p. 62,148 (1999)(Rate Schedule FTS-2).

1. A pipeline cannot require a negotiated rate bid for capacity

The Commission should re-affirm its policy that a pipeline cannot require that a bid utilize a negotiated rate structure. Requiring that bids be in the form of a negotiated rate would violate the fundamental premise of the negotiated rate program that a shipper always can choose to bid the recourse rate in lieu of a negotiated rate. When the Commission established the negotiated rate program, the Commission recognized that the success of this program required that service at the recourse rate be an option for shippers:

> The Commission is particularly concerned about maintaining the integrity of the recourse service. In order to be successful, the recourse service must remain a viable alternative to negotiated service. [74 FERC ¶61,076, p. 61,240]

The Commission has noted that the guarantee of the recourse rate alternative "is intended to give customers the option of returning to cost-based traditional service, if the pipeline ever demands excessive prices or withholds services in the exercise of market power."[4] Thus, "the ready availability of the recourse rate is necessary to limit the pipeline's exercise of market power."[5] The Commission observed that "the failure of the recourse option to act as a check against pipeline market power is an 'impermissible' result."[6]

In this regard, the fact that one shipper has submitted a negotiated rate bid for capacity does not justify requiring other shippers to submit a negotiated rate bid. The Commission has made it clear that only economic-based criteria can be used in awarding capacity.[7] Hence, if two shippers submit competing bids with different rate structures,

[4] *Kern River Gas Transmission Co.*, 99 FERC ¶61,085, p. 61,371 (2002).
[5] *Transwestern Pipeline Co. ("Transwestern")*, 100 FERC ¶61,058, pg. 61,216, para. 37 (2002).
[6] *Transwestern*, 100 FERC ¶61,058, pg. 61,216, para. 37.
[7] *Columbia Gulf Transmission Co., et al.*, 78 FERC ¶61,263, p. 62,124 (1997); *Tennessee Gas Pipeline Co. ("Tennessee")*, 82 FERC ¶61,011, p. 61,044, *order on reh'g*, 83 FERC ¶61,002 (1998).

the pipeline can evaluate the economic value of each bid to determine who gets the capacity (with the caveat that the economic value of a negotiated rate bid is capped at the recourse rate).[8] To allow a pipeline to require that shippers submit a negotiated rate bid would undermine the goal of the negotiated rate program to increase, not decrease, rate flexibility for shippers in obtaining capacity. In addition, requiring a shipper to bid a negotiated rate allows a pipeline to exercise market power in the pricing of capacity.

The Commission should also re-affirm its policy that a pipeline cannot condition construction of an expansion or interconnection on the agreement of shippers to pay a negotiated rate. Here, too, requiring a shipper to pay a negotiated rate undermines the principle that a shipper should always be able to bid the recourse rate instead of a negotiated rate. Therefore, the Commission has correctly held that "this type of tying arrangement would be patently illegal."[9]

2. <u>Recourse rates must be a viable option for pipeline customers</u>

As noted, a shipper must always be able to elect the recourse rate in lieu of a negotiated rate. In addition, the Commission should take steps to ensure that the recourse rate continues to be just and reasonable. In today's regulatory environment, many pipelines' rates have become stale and there are a number of instances in which pipeline revenues far exceed those necessary to recover costs and collect a fair return on investment. While pipelines have clearly performed effectively for their shareholders, NGSA's analysis of pipeline returns makes it clear that we have reached a point where the Commission must take action to ensure that pipeline recourse rates are in line with approved returns. Absent just and reasonable recourse rates, customers are not afforded

[8] *Tennessee*, 82 FERC ¶61,011, p. 61,044.
[9] *CNG Transmission Corp.*, 80 FERC ¶61,401, p. 62,329 (1997).

the true protection needed to have a valid alternative to negotiated rates. It bears emphasis that pipeline transportation "is generally a natural monopoly … so that without regulation the rates of pipeline companies would exceed competitive rates."[10]

NGSA requests that the Commission use this proceeding as a forum to explore ways to ensure that pipeline rates are just and reasonable. Similar to the periodic Section 4 rate filing requirement imposed as a *quid pro quo* for pipelines that chose to use a purchased gas adjustment (PGA) provision for recovery of gas costs in the pre-unbundling era, a similar periodic rate filing requirement could be a prerequisite for pipelines that choose to engage in negotiated rate transactions. There are additional options for rate refreshment.[11] For instance, the Commission could require a pipeline to file a cost/revenue study as outlined in the Commission's regulations.[12] In addition, the Commission already requires a new pipeline to file a new rate case or a cost/revenue study within three years after commencement of operations.[13] This same alternative filing requirement is included in some rate case settlements.[14] At a bare minimum, a pipeline should be required to specifically report a calculation of its actual return on equity earned for the year in its annual Form 2 .[15] If initial screenings indicate that a gas pipeline's rates may no longer be just and reasonable, the Commission could then take

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[10] *Interstate Natural Gas Association of America v. FERC*, 285 F.3d 18, 30 (D.C. Cir. 2002).
[11] See Docket Nos. RM98-10, *et al.*,"Supplemental Comments of Exxon Corporation", dated April 22, 1999; Docket No. RM98-12, "An Incentivized Cost-Based Ratemaking Proposal", filed by BP Amoco on April 22, 1999.
[12] *Trunkline LNG Co. v. FERC*, 194 F.3d 68, 71 (D.C. Cir. 1999).
[13] *Warren Transportation, Inc.*, 82 FERC ¶61,197 (1998); *Maritimes & Northeast Pipeline*, 99 FERC ¶61,093 (2002).
[14] *Wyoming Interstate Co., Ltd.*, 70 FERC ¶61,274 (1995); *Overthrust Pipeline Co.*, 69 FERC ¶61,082 (1994).
[15] The Commission already has a similar requirement for oil pipelines to report in their annual Form 6 the equity return that they earned during the current and prior year (see line 6 of "Annual Cost of Service Based Analysis Schedule" on page 700 of Form No. 6).

any further action that may be warranted.

3. The Commission should continue to maintain a clear distinction between <u>what constitutes a negotiated rate and a negotiated service condition</u>

To ensure that pipelines do not negotiate terms and conditions under the guise of a negotiated rate, there must continue to be a clear demarcation between a negotiated rate and a negotiated service condition.

Negotiated terms and conditions are "related to operational conditions of transportation service." (Order No. 637, p. 31,344). A negotiated service condition "include[s] conditions or activities related to the transportation of gas on the pipeline, such as scheduling, imbalances, or operational obligations, such as OFOs." Other examples include conditions that involve:

1) hourly delivery flexibility,
2) the right to change primary points, and
3) the circumstances in which service can be interrupted.[16]

A negotiated service condition is improper because it would allow a shipper to "receiv[e] a different quality of service from that provided other customers under the tariff."[17] Given that the Commission requires that pipelines provide non-discriminatory service to all shippers, the Commission has appropriately prohibited negotiated service conditions. Special rights, such as MDQ reduction rights and exit fee options, should only be offered via the pipeline's tariff so that the rights are generally available to all shippers.[18]

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[16] *ANR Pipeline Co. ("ANR")*, 97 FERC ¶61,223, pp. 62,016-62,017 (2001).
[17] *ANR*, 99 FERC ¶61,080 (2002).
[18] *ANR,* 97 FERC ¶61,223, p. 62,017; *ANR*, 97 FERC ¶61,252 (2001); *ANR*, 97 FERC ¶61,224 (2001); *ANR*, 97 FERC ¶61,222 (2001).

4. Negotiated rates should not be reflected in a pipeline's discount adjustment

There are some Commission decisions that suggest that in certain circumstances a negotiated rate can be reflected in the discount adjustment in a pipeline rate case. For example, in certain instances the Commission has said that the discount adjustment can include a negotiated rate transaction that was converted from a regular discounted transaction as long as the discount adjustment reflects the greater of the negotiated rate revenues or the discount rate revenues (referred to as the converted rate exemption).[19] The Commission explained that the converted rate exemption is justified because shippers are no worse off than if the transaction had remained a regular discount transaction.

In some other instances, the Commission has said that a negotiated rate discount can be included in the discount adjustment as long as the "pipeline's negotiated rate proposal protect[s] the recourse rate-paying shippers against inappropriate cost shifting." (referred to here as the no cost shift exemption).[20]

However, both the converted rate exemption and the no cost shift exemption violate the basic policies that serve as the foundation of the negotiated rate program. Therefore, the Commission should revisit these exemptions and make it clear that a negotiated rate cannot be included in a discount adjustment. The practical impact of inclusion of a negotiated rate discount in the discount adjustment is that the revenue shortfall associated with the discount (as compared to the recourse rate) is shifted to recourse rate shippers. That would violate the Commission's emphatic policy that

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[19] *Northwest Pipeline Corp.*, 79 FERC ¶61,416, p. 62,754 (1997), *reh'g denied*, 84 FERC ¶61,109 (1998); *Columbia Gas Transmission Corp.*, 92 FERC ¶61,080 , p. 61,338 (2000).
[20] *NorAm Gas Transmission Co.*, 81 FERC ¶61,204, p. 61,872 (1997)

"customers electing the recourse rate should be no worse off as a result of the [pipeline's] use of negotiated rates than they would be absent the use of negotiated rates."[21] This policy means that pipeline's negotiated rate program must be structured so that recourse rate shippers are not harmed by the pipeline's use of negotiated rates. A corollary of this policy is that "any revenue shortfall due to the lower negotiated rates cannot be recovered from existing shippers."[22] Thus, the Commission has made it clear that a pipeline that uses negotiated rates "will not be permitted to reallocate any unrecovered costs [associated with the negotiated rate contracts] to recourse rate shippers."[23] As noted, inclusion of a negotiated rate in the discount adjustment necessarily shifts to recourse rate shippers the costs that the pipeline chose not to recover from the negotiated rate shipper. Hence, the converted rate exemption and the no cost shift exemption should be rejected.

There are additional reasons to reject the converted rate exemption. This exemption appears to be based on the premise that a regular discount and a negotiated rate transaction are interchangeable. But that premise is wrong. Commission policy is that a negotiated rate involves a rate that deviates from the minimum-maximum rate range in the pipeline's tariff, or involves an index rate, formula rate or any other type of complex rate. If a rate fits these criteria, it is a negotiated rate. If the rate does not fit these criteria, it is a recourse rate. As a result, a negotiated rate is outside the cost-based realm associated with a recourse rate; therefore, the pipeline cannot wave a wand and magically transform a recourse rate into a negotiated rate to take advantage of the discount adjustment. Hence, the pipeline cannot initially label a rate as a recourse rate

[21] "Alternative Rate Policy Statement", 74 FERC ¶61,076, p. 61,242.
[22] *Millenium Pipeline Co., et al.*, 97 FERC ¶61,292, p. 62,323 (2001); *see also Southern Natural Gas Co., et al.*, 99 FERC ¶61,345, p. 62,479 (2002).
[23] *Kern River Gas Transmission Co.*, 99 FERC ¶61,085, p. 61,372 (2002).

and then re-characterize the rate as a negotiated rate. When the pipeline and a shipper choose to do a negotiated rate transaction, the two parties have voluntarily opted-out of the recourse rate regime. In choosing to do a negotiated rate transaction, the pipeline voluntarily assumes the risk that it might recover less revenue than it would via a recourse rate. Therefore, a negotiated rate cannot be treated as a discount for purposes of the discount adjustment.

The Commission has recognized this principle in the related setting of the removal of the price cap on short-term releases. The Commission found that the post-bid exemption cannot apply to a prearranged short-term release at the recourse rate because there is no recourse rate applicable to the release.[24] The same reasoning applies to a negotiated rate. Here, too, the recourse rate does not apply. Hence, a negotiated rate cannot be a discount rate for purposes of making discount adjustments in rate proceedings.

5. Other Commission Policies Must Be Successful to Create a Fair Regulatory Environment for the Negotiated Rate Program

For customers to have confidence in the negotiated rate program, the underlying regulatory environment needs to work effectively. For example, adoption of the proposed revisions of the Standards of Conduct in Part 161 of the Commission's regulations that govern dealings between a pipeline and an affiliate will reduce the risk that an affiliate can gain an unfair competitive advantage through negotiated rates or

[24] Order No. 637, " Regulation of Natural Gas Transportation Service and Regulation of Interstate Natural Gas Transportation Services", Order No. 637-A, FERC Statutes and Regulations (Preambles) ¶31,099, p. 31,568, *order on reh'g*, Order No. 637-B, 92 FERC ¶61,062 (2000), *aff'd in part and remanded in part sub nom*. *Interstate Natural Gas Association of America v. FERC*, 285 F.3d 18 (D.C. Cir. 2002).

otherwise.[25] Also, a well-functioning market-monitoring program, including periodic audits, is essential to ensure pipelines are promptly posting all available capacity and services, especially in those instances where negotiated rates exceed the recourse rate.[26] As discussed more fully below, tariffs must contain clear standards regarding the posting, bidding and awarding of capacity. These Commission policies and initiatives will help ensure that the negotiated rate program operates effectively.

Question C: Do the negotiated rate filing requirements provide sufficient information for necessary transparency of the transactions?

Commission policy is that a pipeline must file either the negotiated rate contract or a tariff sheet that describes the contract, no later than the day on which service begins (or the next business day if the start date is a non-business day).

As discussed below, the Commission should modify its filing requirements with respect to negotiated rates in two ways. First, the Commission should require a pipeline to file both the negotiated rate contract and a tariff sheet that describes the contract. Second, the Commission should require a pipeline to make this filing at least 30 days prior to the initiation of service under a long-term (one year or longer) transaction or in cases where a negotiated rate deal is completed well in advance of when service begins under the contract.

1. A pipeline should file both the contract and a tariff sheet for each negotiated rate transaction

The Commission has given pipelines the option of filing the actual negotiated rate contract or alternatively, a tariff sheet that lists all the pertinent information relative to

[25] Docket No. RM01-10, "Notice of Proposed Rulemaking -- Standards of Conduct for Transmission Providers", FERC Statutes and Regulations (Proposed Regulations) ¶32,555 (2001).
[26] *Transwestern*, 100 FERC ¶61,058, pg. 61,217, para. 41-42; *Transwestern*, 100 FERC ¶61,120, p. 61,475 (Appendix B)(2002).

that contract. When the Commission first implemented the negotiated rate program, pipelines typically filed the negotiated rate contract. However, over the years the prevailing practice has changed, and pipelines now typically file a tariff sheet that describes the contract, in lieu of filing the contract.

A pipeline should be required to file each negotiated rate contract. There is some level of subjectivity regarding what details of a negotiated rate contract should be reflected in a tariff sheet that is filed in connection with the transaction. What one party may consider an immaterial deviation, another party might see as material. Consequently, there is too much of a risk that the pipeline could omit details of a transaction that shippers see as important. The Commission has already uncovered instances where a pipeline failed to describe important details of a negotiated rate transaction in its tariff sheet filing.[27] Without full disclosure of the contract, the Commission and shippers have only limited ability to monitor negotiated rate transactions to ensure that all shippers are treated fairly.

In addition, because many negotiated rate contracts are lengthy, and involve complex rate provisions, it can be difficult to decipher the interplay of the various provisions of many negotiated rate transactions when contract provisions are presented in footnote form on a tariff sheet. The simple fix for these problems is to require a pipeline to file the contract for each negotiated rate transaction. This requirement does not impose any burden on pipelines.

A pipeline should also file a tariff sheet that fully describes the transaction. The tariff sheet ensures that shippers and the Commission can readily access information

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[27] *See, for example, Northern Natural Gas Co*., 89 FERC ¶61,195, p. 61,600 (1999)(tariff sheet filed by pipeline fails to adequately describe the pricing options in the negotiated rate contract).

about each of a pipeline's negotiated rate transactions. The description of the negotiated rate transactions in tariff sheets also allows parties and the Commission to easily view the various negotiated rate transactions of a pipeline. This facilitates analysis of whether the pipeline is treating similarly-situated shippers in an equal manner.

The Commission should also re-affirm that a pipeline must comply with these filing requirements whenever it revises a negotiated rate transaction. When a negotiated rate transaction is revised, the Commission and shippers need to be able to look at the new version of the transaction to determine whether it is proper and whether similarly-situated shippers are being treated equally.[28] For example, if the primary receipt or delivery points in the contract are changed, there may be other similarly situated shippers that would seek a similar deal.

2. The filing deadlines for negotiated rate transactions should be revised

One aspect of the negotiated rates program that continues to be problematic is the lack of a review and comment period prior to the effectiveness of the contract. The Commission's current policy of allowing a pipeline to wait until the implementation date of a negotiated rate transaction to make its filing can create significant problems. The Commission has suspended and initiated investigations of several negotiated rate transactions because of concerns that the transactions reflect the exercise of market power by the pipeline or are unduly discriminatory.[29]

[28] *See Transwestern*, Docket No. RP97-288-004 (Aug. 7, 2002)(Commission approves amendment to negotiated rate transaction that changes the primary points)(unpublished).

[29] *Transwestern*, 100 FERC ¶61,120, p. 61,475 (Appendix B); *PG&E Gas Transmission Corp., Northwest Corp. ("PG&E")*, 98 FERC ¶61,001 (2002); *Transwestern*, 96 FERC ¶61,138 (2001); *PG&E*, 95 FERC ¶61,475 (2001); *PG&E*, 95 FERC ¶61,168 (2001).

We recognize that many negotiated rate transactions are for one month or less, which means that as a practical matter the Commission is unlikely to complete its review of the transaction before it has terminated.[30] In these instances, the Commission cannot prevent the competitive injury that is caused by preferential transactions. However, for longer-term transactions or those transactions completed far in advance of implementation of the transaction, review and comment on the transaction before it goes into effect is both practical and imperative.

Consequently, the Commission should require a pipeline to make its filing in connection with a long-term (one year or longer) negotiated rate transaction by the later of 30 days before implementation of the transaction or three days after the deal is consummated. Likewise, if a short-term transaction is consummated more than 30 days in advance of its implementation, the pipeline should make its filing by the later of 30 days before implementation or three days after the deal is consummated. To ensure that a pipeline can implement without delay short-term transactions that are consummated less than 30 days before implementation, NGSA is amenable to continuing the current procedures where pipelines are required to make the filing no later than the date on which gas begins to flow pursuant to the transaction. For shorter transactions, however, the Commission should retain the right to suspend the rate, and to require refunds if the Commission finds that the rate is excessive or otherwise improper.

A one-year demarcation for the 30 day advance notice filing requirement is justified. For example, different posting and bidding requirements apply to capacity

[30] *Trailblazer Pipeline Co.*, Letter Order, Docket No. RP97-336-004 (June 8, 2000)(Commission approves 17 day negotiated rate deal 8 days after deal terminates)(unpublished); *Great Lakes Gas Transmission Co.*, 90 FERC ¶61,232 (2000)(Commission approves 29 day negotiated rate deal 10 days after deal terminates);

releases with durations shorter than one year as compared to longer transactions.[31] Likewise, different posting and bidding requirements apply to a pipeline's sale of capacity that is available for less than one year as compared to longer transactions.[32]

The filing deadlines proposed by NGSA track those applicable in related settings. For example, a pipeline has to file a contract that materially deviates from the tariff (a so-called non-conforming contract pursuant to 18 C.F.R. §154.1(d)) at least 30 days prior to the effective date of the contract.[33] The 30-day advance notice ensures that the Commission and other shippers can review the contract before it goes into effect. This same policy should apply with full force to negotiated rate transactions and, hence, a similar filing deadline for long-term negotiated rate transactions should be utilized.

Question D: Does the recourse rate option effectively mitigate pipeline market power? Are further mitigation measures necessary? And if so, which measures?

As noted in our response to Question B, a crucial safeguard to prevent the exercise of market power by a pipeline in implementing a negotiated rate program is that each pipeline's recourse rate should be a viable alternative to a negotiated rate. Also, a fair regulatory environment that effectively limits the opportunity for affiliate preferences and allows the Commission and pipeline industry participants to adequately monitor whether negotiated rate transactions are fair will contribute significantly to the success of the negotiated rates program. In addition, the use of appropriate advance postings that

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PG&E, Letter Order, Docket No. RP99-518-011 (March 30, 2000)(Commission approves 31 day negotiated rate deal one day before deal terminates)(unpublished).

[31] North American Energy Standards Board ("NAESB") Standard 5.3.2, adopted in Order No. 587-O, FERC Statutes and Regulations (Preambles) ¶31,129, p. 30,179 (2002).

[32] *Columbia Gas Transmission Corp.*, 94 FERC ¶61,301, p. 62,108 (2001).

[33] Order No. 637, FERC Statutes and Regulations (Preambles) ¶31,091, p. 31,343.

allow all parties an opportunity to attain capacity can reduce the possibility of discrimination.

Question E: Should the Commission disallow negotiated rates above the maximum recourse rate? Should the negotiated rate be limited to a certain multiple of the maximum recourse rate? Should the negotiated rate be limited to adjusting the levels of the reservation demand and commodity rate components, but the total revenue responsibility over the term of the contract remain equal to the revenue responsibility under the recourse rate?

As noted, if properly tailored, the negotiated rate program provides added rate flexibility for shippers. Other than the changes outlined in these comments, NGSA believes that further restrictions on negotiated rates program may unnecessarily reduce the value of the negotiated rate program.

Question F: Should the Commission disallow negotiated transportation rate deals based on price differentials of delivered gas between hubs?

NGSA has concerns regarding index-based negotiated rate deals in today's environment. Rather than discontinuing the program, however, NGSA suggests that the Commission adopt as part of the program the mitigation measures outlined in our response to Question G, below.

However, if the Commission decides to ban all index rate transactions, the Commission should allow existing transactions to remain in effect until the end of the primary term of the contract, subject to the conditions outlined immediately below. Immediate termination of the transactions would cause unnecessary market disruption and would be unfair to shippers that have structured marketing deals in reliance on their contracts.[34]

[34] The Commission has used a similar grandfathering approach in related settings. For example, when the Commission banned buy-sell transactions, the Commission allowed existing buy-sell transactions to remain in effect (Order No. 636, "Pipeline Service Obligations and Revisions to Regulations Governing Self-

Neither the pipeline nor the shipper with a grandfathered index rate transaction should be allowed to renew the transaction via a regulatory or contractual renewal right (such as an evergreen and rollover clause). The Commission might find it appropriate to permit a transition period that allows parties with near-term contract expirations to have more time to renegotiate index rate deals.

Of course, parties should retain the right to file a complaint that asks the Commission to terminate a grandfathered transaction before the end of its primary term. Termination would be appropriate if, for example, unduly discriminatory conduct or an abuse of market power has been alleged.

Question G: If such index price differentials continue to be allowed, should some limits or restraints be placed on them? If so, what limits might be used or appropriate?

The Commission's inquiry in this docket reflects a fundamental desire to take positive action to foster public confidence in free and open natural gas markets, and to eradicate even the appearance of impropriety in connection with index-based negotiated rates transactions. NGSA believes that, rather than imposing an outright ban on the index transactions that are now the focus of this proceeding, a more direct approach would be to focus on creating and expanding market rules that promote transparency and mitigate even the potential for anticompetitive conduct. This approach mirrors the Commission's initiatives in developing standardized market designs for the electric transmission industry.

Implementing Transportation and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol", FERC Statutes and Regulations (Preambles) ¶30,939, p. 30,416, *order on reh'g*, Order No. 636-A, FERC Statutes and Regulations (Preambles) ¶30,950, p. 30,569, *order on reh'g*, Order No. 636-B, 61 FERC ¶61,272 (1992), *notice of denial of reh'g*, 62 FERC ¶61,007 (1993), *aff'd in part and vacated and remanded in part sub nom. United Distribution Companies v. FERC,* 88 F.3d 1105 (D.C. Cir. 1996)).

NGSA believes that a similar market standardization effort should focus in the first instance on the issue of pipeline capacity allocation in the context of index-based transactions. The market standardization effort outlined below would respond to the Commission's desire to constrain the potential exercise of pipeline market power in index-based transactions and to forestall the market distortions that might result from that power.

In lieu of an outright ban on index-based transactions, the Commission should impose the following conditions on any pipeline that opts to offer these transactions:

1) the pipeline must post the transactions on its electronic bulletin board as soon as an agreement in principle is reached between the pipeline and the shipper;

2) once the transaction is posted, the pipeline must allow competitive bids from other parties for all or a portion of the capacity, and

3) the pipeline must sell as interruptible service all unused capacity, including currently subscribed capacity that is not being utilized for firm service, at any price in excess of variable costs that clears the market, up to the recourse rate, on a continuous basis at every scheduling opportunity

These conditions will minimize the risk of inappropriate conduct by a pipeline that performs these transactions.

Chairman Wood has pointed to the problems that can be caused by index rates because of the way these rates give a pipeline an incentive to exercise market power :

> … I have come to believe that negotiated gas transportation rate deals between shippers and regulated transporters based on price differentials between hubs which may rise above the recourse rate may not be good public policy. Order No. 636 led the pipelines unbundled transportation (regulated service) from commodity sales (competitive service). These sorts of transportation pricing mechanisms begin to blur the once clear role of pipelines as open access transporters with no direct interest in the price of the commodity.
> We have seen negotiated rates that are multiples of the maximum rate in other cases.[35]

[35] *PG&E*, 100 FERC ¶61,051, p. 61,189 (concurring opinion of Chairman Wood) (July 11, 2002).

The Commission recently found that Transwestern made "a clear and conscious effort" to give preferential access to capacity to shippers that were willing to agree to a negotiated rate that required them to share profits with the pipeline based on spot market price differentials.[36] Index rates also can create an incentive for a pipeline to operate its system in an inefficient manner during certain periods to reduce the level of available capacity.

To ensure fair and open capacity allocation, a pipeline should be required to sell as interruptible service all currently subscribed capacity that is not being utilized for firm service, including subscribed capacity, at any price in excess of variable costs that clears the market, up to the recourse rate, on a continuous basis at every scheduling opportunity.[37] This must-offer requirement ensures effectively that a pipeline cannot withhold capacity from the market, which would be unjust and unreasonable. To allow shippers and the Commission to monitor on a real-time basis the index rate transactions executed by the pipeline, the pipeline should be required to post all negotiated rate transactions as soon as the transaction is agreed to in principle by the parties. There should be competitive bidding in connection with any posted index rate transaction to guarantee that all shippers have an opportunity to acquire the capacity.

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[36] *Transwestern*, 100 FERC ¶61,058, pg. 61,213, para. 18.

[37] *See* "Initial Comments of Amoco Production Company and BP Energy Company in Qualified Support of Notice of Proposed Rulemaking and Proposal for Additional Requirements", filed in this proceeding on Dec. 20, 2001.

For the reasons discussed above, NGSA believes that the Commission should continue the negotiated rate program but with the revisions advocated by NGSA to ensure that the program best achieves the Commission goal of allowing flexible pricing while at the same time deterring the exercise of market power by pipelines.

Respectfully submitted

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By: ______________________________
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September 25, 2002

CERTIFICATE OF SERVICE

Pursuant to Rule 2010 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.2010 (2001), I hereby certify that I have this day served the foregoing document upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C. this 25th day of September 2002.

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Kenneth M. Albert

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