



### III. INTRODUCTION AND EXECUTIVE SUMMARY

NGSA supports the Commission's policy, as sanctioned by the court in *AGD v. FERC*,<sup>2</sup> that permits pipelines to discount transportation rates in order to retain and promote additional throughput on interstate natural gas pipelines. In addition, NGSA also supports the Commission's policy that allows pipelines generally to adjust their throughput in subsequent rate cases in order to avoid penalizing pipelines for offering discounts and to help ensure that pipelines have a fair opportunity to recover their cost of service.<sup>3</sup> In sum, NGSA believes that the Commission's discounting policy promotes the Commission's goals of encouraging competition, increasing throughput on interstate pipelines, sending appropriate market signals, and providing more flexible service options for shippers. The Commission should let competition work.

Order No. 436 was a watershed event in the history of natural gas regulatory policy. In this order, the Commission ushered in a new vision of government oversight that recognized the importance of the free market in the operation of the natural gas markets. While hewing to the statutory goals of the Natural Gas Act<sup>4</sup> and the continued need to protect consumers from the exercise of monopoly power, the Commission began the first bold steps to recognize the benefits of competition – steps that the Commission strengthened and extended through Order Nos. 636 and 637, a variety of policy statements, as well as numerous implementation proceedings.

In Order No. 436, the Commission first adopted a policy allowing pipelines to provide selective discounts to customers based on the demand elasticity of the shippers as a means of

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<sup>2</sup> *Associated Gas Distributors v. FERC*, 824 F.2d 981, 1010-12 (D.C. Cir. 1987).

<sup>3</sup> *Interstate Natural Gas Pipeline Rate Design*, "Policy Statement Providing Guidance with Respect to the Designing of Rates," 47 FERC ¶ 61,295 at 62,056, *order on reh'g*, 48 FERC ¶ 61,122 (1989)(herein "Rate Design Policy Statement").

<sup>4</sup> 15 U.S.C. § 3301 *et seq.* (2005).

encouraging and maximizing pipeline throughput.<sup>5</sup> The Commission has maintained the position that increased throughput prompted by such discounts benefits all shippers, including the pipeline's captive customers, by allowing pipelines to spread fixed costs over more units of service.<sup>6</sup> In addition the Commission's policies allow a pipeline to adjust its throughput in its next rate case so that discounted volumes are not assumed to flow at maximum rates (if a pipeline can prove that discounts were given in order to meet competition and are not related to affiliate transactions, which are subject to a greater degree of scrutiny). Thus, the discount adjustment allows pipelines the opportunity, but not the certainty, to recover their costs.

Over the years, pipeline discounting to meet competition and adjustments for those discounts in rate cases have become standard practice for interstate natural gas pipelines. However, some parties have raised concerns with this policy, particularly with regard to its application to "gas-on-gas competition."<sup>7</sup> For example, some opponents of the policy have argued that one of the main justifications for discounting, *i.e.*, providing benefits to captive customers, is not realized when the discounts are provided for gas-on-gas competition. This is in contrast to situations where either the discount is provided to attract new, incremental demand, or

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<sup>5</sup> Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 436, *FERC Stat. & Regs., Regulations Preambles* (1982-1985) ¶ 30,665 at 31,543-45 (1985) ("Order No. 436"), *vacated and remanded, Associated Gas Distributors v. FERC*, 824 F.2d 981 (D.C. Cir. 1987), *readopted on an interim basis*, Order No. 500, *FERC Stats. & Regs.* ¶ 30,761 (1987).

<sup>6</sup> Order No. 436 at 31,542-45; *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, Order No. 636, *FERC Stats. & Regs., Regulations Preambles* [1991-1996] ¶ 30,939 (Apr. 8, 1992), *order on reh'g*, Order No. 636-A, *FERC Stats. & Regs., Regulations Preambles* [1991-1996] ¶ 30,950 (Aug. 3, 1992), *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), *reh'g denied*, 62 F.E.R.C. ¶ 61,007 (1993), *aff'd in part and remanded in part sub. nom, United Distrib. Cos. v. FERC*, 88 F.3d 1105 (D.C. Cir. 1996), *cert. denied, Associated Gas Dist. v. FERC*, 520 U.S. 1224 (1997); *order on remand*, Order No. 636-C, 78 F.E.R.C. ¶ 61,186 (1997); *order on reh'g*, Order No. 636-D, 83 F.E.R.C. ¶ 61,210 (1998).

<sup>7</sup> The Commission's use of the phrase "gas-on-gas" competition in the NOI refers to those situations where the competition for a shipper's business is between natural gas pipelines, as opposed to alternative fuel sources. NOI at 6.

to a customer who has alternative fuel options and who is being offered a discount in order to keep that customer from fuel switching. Parties that have challenged the distinction between discounts given for gas-on-gas competition and discounts given for gas-on-alternative fuel competition argue that the interstate grid loses overall revenue when discounts are provided in order for pipelines to compete with one another.

While we appreciate the Commission's desires to consider these concerns, NGSA urges the Commission to refrain from trying to "fix" something that is not broken. For over 20 years, the Commission consistently has implemented policies that promote a more competitive market. Selective discounting is but one element, albeit an important one, that allows pipelines to fully participate in the market and, more importantly, it has proven to be successful in stimulating additional competition. Moreover, without the ability to adjust rates for discounting, the Commission is severing its regulatory pact to provide the pipeline with the opportunity to recover its costs.

Without the ability to discount to meet gas-on-gas competition, pipelines lose an invaluable tool to compete in the marketplace. Discounts provided to meet gas-on-gas competition are important for pipelines to both attain incremental new load and to maintain their existing customer base. While NGSA believes that the Commission's inquiry in this proceeding is directed toward a reexamination of whether the discount adjustment should remain intact and not toward eliminating the ability to discount, NGSA nonetheless urges the Commission to continue to allow pipelines to provide selective discounts and to allow discount adjustments. Whether or not to offer a discount is a purely economic decision, and one in which the Commission should not interfere given its continued progress toward more competitive markets.

A change in current discounting practices could lead to other unintended consequences in the natural gas market as well. As explained in more detail below, changes to the current pipeline discounting practices could adversely impact investment decisions by pipelines and other energy sectors, such as LNG facilities and new gas-fired generation. Also, it could result in disincentives for producers to find much-needed supply and in greater balkanization of the market.

#### **IV. COMMENTS**

As stated above, NGSa strongly believes that the Commission should maintain its current policy on selective discounting, as set forth in Order No. 436 and as approved by the D.C. Circuit in *AGD v. FERC*. In addition to the specific questions posed in the NOI, the Commission's NOI has raised broad policy questions, the answers to which have industry-wide ramifications. It is on these broader policy issues that NGSa wishes to comment.

##### **A. Benefits to Captive Customers**

The Commission's theory as to how discounting should benefit captive customers was, and remains, sound. The ability to offer discounts is a tool that effectively provides pipelines with the opportunity to compete against other natural gas pipelines and other fuel sources. The ability of a pipeline to offer a discount allows the pipeline to maximize throughput by obtaining new customers or retaining existing loads and spreading its fixed costs across more units of service than had it not been able to provide discounts. In addition, discounting by pipelines provides for healthy competition between pipelines, which may have the effect of encouraging pipelines to be more efficient. Efficiencies help to lower costs, and therefore, should result also in reduced rates to all shippers, including captive shippers, provided that those lower costs are subsequently flowed through in a pipeline rate proceeding.

Under the Commission’s selective discounting policy, captive customers reap the benefits that are associated with discounting and increased pipeline efficiencies only in subsequent section 4 rate cases. Unfortunately, any benefit to captive customers can only be achieved through pipeline rate cases, which are now few and far between. Thus, the benefits of discounting to captive customers may remain, in many instances, only theoretical. The lack of pipeline rate cases to recognize the benefits associated with discounting, however, is not a reason to eliminate discount adjustments themselves.

In a general pipeline rate case, all facets of a pipeline’s costs and revenues are examined along with the appropriate billing determinants to use when re-designing rates. Discount adjustments are but one of the elements that factor into the ultimate maximum tariff rate for shippers. Any new incremental load or lost load that occurs during the test period also is considered and, depending on the balance between all of the variables,<sup>8</sup> the pipeline may need to increase or decrease its rates accordingly. However, disallowing a discount adjustment, as a generic matter, will not necessarily result in lower maximum rates. In fact, it could actually lead to higher rates depending on the circumstances. There is a much bigger picture that needs to be considered than just the discount adjustment alone.

For instance, a discount may have been provided in order to retain existing load or to attract new incremental load. In those circumstances, the only way to truly measure the “benefit” to the system is to compare the rates based on providing a discount to *retain* (or *increase*) load with the rates that would result from *losing* that load, absent discounting. Ultimately, one may not have proof to what extent the pipeline was able to maintain the highest

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<sup>8</sup> For example, increased or decreased costs due to expansions, upgrades, or greater efficiencies due to mergers; relative competition that the pipeline is experiencing; as well as the elasticity of the customers.

level of service and revenue on its system because no one knows what business decisions might have been made by pipeline customers absent a discount. Yet, one must assume that when the discounts are the result of arms-length negotiations, the pipeline made business decisions that were in the best interests of its customers and its shareholders. When the Commission takes away the pipeline's ability to adjust for discounting, the Commission is actually second guessing the pipeline's business decisions, which the Commission has historically been very reluctant to do.<sup>9</sup> Without a discount adjustment, a pipeline may in fact decide that it is less risky to just sit on unsubscribed capacity and have rates recalculated to allow full cost recovery from its captive customers, rather than to discount its rates and risk under-recovery. Obviously, in that situation, all captive customers are worse off.<sup>10</sup>

When the Commission made the commitment to promote more competition for natural gas transportation and to encourage more than one pipeline to serve the same markets, it did this with an understanding that, all things considered, more competition would benefit consumers. However, while promoting competition, the Commission did not make a choice to put pipelines fully at risk for competition and, therefore, the regulatory compact of providing pipelines with the *opportunity* to recover their costs still remains. This compact is what provides the required certainty that encourages a variety of needed infrastructure investment.

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<sup>9</sup> See *Southern Natural Gas Co.*, 102 FERC ¶ 61,134 (2003) (“[N]or do we have a policy that prohibits or discourages a power plant owner from using gas to generate electricity . . . . [W]e believe that these are business decisions to be made by the pipeline and power plant owner and we will not interfere with those decisions.”); *Columbia Gas Transmission Corp.*, 101 FERC ¶ 61,337 (2002) (“[I]n *Southern Natural Gas Co.*, the Commission stated it is not appropriate to second guess a pipeline's business decision to offer a discount to a non-affiliated shipper where there is a legitimate, competitive reason to offer such a discount.”).

<sup>10</sup> Pipelines are not required to sell capacity below maximum tariff rates. Therefore, the Commission cannot find that holding unsubscribed capacity in lieu of selling at discounted rates is imprudent.

## **B. Unintended Market Consequences**

NGSA is concerned that changes to the Commission's discounting policy also may have unintended consequences for the natural gas market. If pipelines are not permitted to adjust their rates for gas-on-gas discounting, then one must presume that pipelines will be less apt to provide those discounts to their customers and they may, as described above, find it less risky to hold unsubscribed capacity rather than to risk discounting at all.<sup>11</sup> NGSA believes the natural gas market works well and that the Commission should be cautious when attempting to make changes that could adversely impact the market.

### **1. Discouraging Drilling and Production**

NGSA encourages the Commission to continue its existing selective discounting policy. As a general matter, if discounting to meet gas-on-gas competition is eliminated, this could increase the costs to those producers that currently receive such discounts. This could negatively influence whether a producer finds it economical to drill and produce in a certain area. Moreover, if forced to pay maximum tariff rates to move gas out of certain production areas, particularly offshore or for marginal wells, in some circumstances this could impact development, or even lead to the premature abandonment of existing gas wells. Given the declining domestic supply, burgeoning demand, and the tight natural gas market forecasted for the future, it is not prudent to adopt policies that might lead to less gas production.

Contrary to the statements made by the Office of Administrative Litigation in this proceeding, permitting pipelines to adjust their rates to reflect discounting does not provide producers "with *less* incentive to discount their commodity prices." Producers do not make a

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<sup>11</sup> This inquiry does not precisely clarify whether the Commission only is considering disallowing discount adjustments. Again, NGSA emphasizes that the Commission should retain pipelines' ability to discount as well as the ability to take the discount adjustment.

conscious decision to “discount” but rather, there is a competitive, liquid market price for gas at any given location and producers are simply “price-takers.” As market participants, we are equally concerned about having the most cost-efficient means of getting gas to market so that we have *more* incentive to find and produce incremental gas supply. That translates into allowing competition to work and ensuring that excessive, inefficient, or uncompetitive rates do not stand between the producer and end user. When transportation rates are not competitive and are artificially high due to a lack of discounting, inappropriate price signals result, which can create higher overall market prices for consumers. In today’s market environment, we strongly question whether these are outcomes that the Commission wishes to promote. Instead, the industry should promote policies that result in lower costs and greater access to supply, which will ultimately lower prices to consumers. That is simply not accomplished by policies which interfere with competitive market signals, increase costs, discourage needed infrastructure, and inhibit new gas supplies.

## **2. Balkanization of the Market**

NGSA is concerned that the elimination of the discount adjustment for discounts given for gas-on-gas competition, and the resulting disincentive for pipelines to discount, could lead to the balkanization of the natural gas market. If a transportation rate in an unconstrained market is uneconomic or higher than the basis differential, producers and third-party marketers will no longer find it profitable to hold transportation into market areas and instead, likely will begin to sell their gas primarily upstream, closer to the production areas. This in turn leads to fewer supply alternatives in the market area and requires shippers with significant load requirements to purchase more long-haul transportation. Ultimately this is a burden on the captive customers who

are the very class of customers that the Commission has been concerned about in maintaining its discount policy.

However, the more likely scenario is that eliminating the current discounting practices would significantly change the market dynamics and widen the current basis differentials themselves. For the same reasons that the Commission implemented straight-fixed variable rate design to promote competition between markets at variable costs, eliminating discounting will likely increase the margin differentials between the market and production areas and lead to less overall competition. When transportation prices are not easily responsive to the market, this hinders the market's ability to respond to changing market dynamics and corresponding competitive pressures. The Commission must refrain from taking steps that create unnecessary barriers to the movement of prices and to the fundamental operation of natural gas markets.

### **3. Effect on Capacity Release**

If pipelines are less likely to discount because of the elimination of the discount adjustment, this will reduce competition by taking a major player out of the market. Pipelines now compete with their customers in the capacity release market, which helps to reduce the level of market power that any one market participant may have. For example, in the absence of pipeline discounting, there may be many pipeline delivery points where an LDC becomes the only party that can provide a lower-than-max-FT rate. By prohibiting the pipeline from participating against released capacity, the Commission would effectively be conveying market power to one party, thus eliminating competition and increasing end use prices. In the post-Order No. 636 era, we have seen that it is best to allow the gas market to work to the maximum extent possible without government intervention.

#### **4. Impact on Infrastructure Development**

The Commission has understood the need to provide discounted-type rates to foster infrastructure development, for example, when it permitted offshore pipelines to offer flexible rate schedules under FTS-2 to those customers that were willing to dedicate all production from their attached reserves on that particular pipeline. Moreover, discounting provides the needed flexibility for pipelines to offer capacity to those shippers that can increase their incremental load, which can assist in bringing on new, desperately needed, gas-fired power generation. While adding to the pipeline's overall revenue, the economics of the project may simply not support paying the pipeline's full maximum tariff rate.

#### **C. Placing the Burden on Pipelines to Substantiate All Unaffiliated Discounts is Unworkable**

NGSA believes that the Commission is correct in its statements that it would be extremely difficult in a rate case to analyze the discounted rate transactions and determine with any degree of certainty why each discount was provided. It would not only be difficult, but also time consuming and expensive in the rate case context to attempt to achieve even a rough justice underlying the rationale for each specific discount. Given the fast-paced fluid nature of today's market, even the pipeline may not be able to assess with specific certainty at the time the decision is made precisely what "type" of competition is requiring the pipeline to offer a discounted transportation rate. In addition, NGSA is concerned that regulatory attempts to distinguish between types of discounts might discourage pipelines from offering discounts at all, thereby potentially losing incremental load, or losing load to an alternative fuel, or even losing existing customers when the pipeline cannot take the steps needed to meet competition.

Moreover, as the Commission has recognized, discounts that might appear to have been given to meet gas-on-gas competition might also keep a shipper from investing in alternative fuel

capability, thus increasing rates to all other end-use customers. But, it would be extremely difficult, if not impossible, for the pipeline to be able to prove this in order to substantiate that claim in a rate case. In addition, and as the Commission also has noted, interstate pipelines face competition from intrastate pipelines which are not subject to the Commission's jurisdiction. Thus, any attempt to prohibit interstate pipelines from discounting to meet gas-on-gas competition to respond to competition from the intrastate pipelines could result in a loss of throughput and hence adversely impact all of the interstate pipeline's customers.

Given the fluidity of the market and the practical difficulties of distinguishing between types of discounts, NGSA urges the Commission to retain its current policy and to refrain from any attempt to treat non-affiliate discounts differently based on a presumed reason for the discount.<sup>12</sup> We question how the Commission could continue to regulate effectively if it questions and second guesses all non-affiliated, arms-length transactions. Except for instances of misconduct, one must assume that a pipeline will do what is in the best interests of its stockholders and its customers to maintain its existing load and to increase service and revenues to the extent that it can. Regulating without a presumption that a pipeline will only discount when it is in the best interest would simply be unworkable and unwieldy.

#### **D. Alternative Policy Choices**

Finally, in the NOI the Commission requested comments on what alternative changes in the discount adjustment policy could be considered to minimize adverse effects on captive customers. As indicated above, NGSA first and foremost urges the Commission to take steps to ensure that benefits from the increased load brought about by discounts are actually realized by

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<sup>12</sup> As discussed infra, NGSA continues to support the Commission's heightened scrutiny of affiliate discounts.

captive customers by reviewing pipeline rates. Ten years or more between pipeline rate reviews makes any potential benefits illusory.

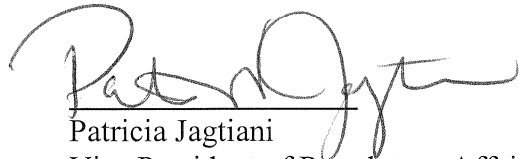
With regard to the Commission's discount policy as applied to affiliates, NGSAs requests the Commission maintain its policy of subjecting affiliate discounts to heavier scrutiny. NGSAs strongly supports the Commission's efforts in Order No. 2004 to make pipeline-affiliate transactions, including discounts, more transparent, thereby giving all shippers more confidence that they may be able to detect discrimination on a more timely basis. At the same time, however, it is not necessary that the Commission prohibit all affiliate discounts. Sufficient protections exist under the current Standards of Conduct for Transmission Providers to guard against undue discrimination.

NGSAs believes that gas-on-gas discounting is a necessary by-product of promoting competition into the natural gas transportation market. There undoubtedly always will be a tension between promoting competition and taking all measures that may appear to protect the captive customer. In the end, depending on the particular circumstances of the market (customer elasticity, market constraints, pipeline business practices, etc.), it may not be possible to know with absolute certainty what type competitive pressure required a given discount. However, NGSAs urges the Commission to adhere to its principles of the last 20 years advancing competition as the best option to provide benefits to all parties, including captive customers. It appears to be working well.

NGSAs asks the Commission to maintain the current policy of allowing selective discounting and an adjustment to rates based on a presumption that discounts given to non-affiliates are given to meet competition. NGSAs also believes that it would be unworkable and unnecessary to require pipelines to justify all non-affiliated discounts that they provide.

**WHEREFORE**, for the foregoing reasons, the Natural Gas Supply Association respectfully requests that the Commission maintain its current discounting policies consistent with the Comments set forth above.

Respectfully submitted,



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