

## REPORT OF THE NATURAL GAS REGULATION COMMITTEE

This Report summarizes several major gas policy developments occurring at the Federal Energy Regulatory Commission (Commission or FERC) in 2001, including the FERC's: (1) interpretation and implementation of Order No. 637 on a case-by-case basis; (2) reversal of its prior policy requiring pipelines to obtain pre-approval before contracting for off system capacity; (3) initiatives to alleviate the energy crisis in the West, including waivers of existing regulatory requirements to expedite the construction of new interstate pipeline transportation capacity; and (4) notice of proposed rulemaking on standards of conduct governing interstate pipelines' relationships with electric utilities and other energy affiliates.

### I. RULINGS ON PIPELINE FILINGS TO IMPLEMENT ORDER NO. 637

On February 9, 2000, the Commission issued Order No. 637<sup>1</sup> to foster competition and increase efficiency across the interstate natural gas pipeline grid. In Order No. 637, the Commission revamped its existing policies with respect to many key elements of interstate natural gas transportation by promulgating new regulations relating to, *inter alia*, scheduling procedures, segmentation and flexible point rights, imbalance management services, penalties and Operational Flow Orders (OFOs). Notably, the new and enhanced policy initiatives adopted in Order No. 637 were designed to emphasize a "service-oriented" approach to interstate natural gas transportation in an effort to provide shippers with a more complete arsenal of tools to compete with interstate pipelines and each other on a level playing field.

To effectuate its Order No. 637 goals, the Commission required pipelines to make compliance filings implementing the policies set forth in the new regulations or, alternatively, to demonstrate how a particular pipeline's existing tariff and operating practices are in compliance with the Order No. 637 requirements.<sup>2</sup> This section of the *Natural Gas Regulation Committee Report* summarizes the major requirements of Order No. 637 and highlights the Commission's application of its new policies and regulations in a few of the individual pipeline implementation cases. Some of the FERC's decisions in the pipeline implementation cases have involved Commission review of settlements reached between the pipeline and its shippers with respect to the Order No. 637 requirements and, although

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1. Order No. 637, *Regulation of Short-Term Natural Gas Transportation Services, and Regulation of Interstate Natural Gas Transportation Services*, [Regs. Preambles] III F.E.R.C. STATS. & REGS. ¶ 31,091 (2000), *order on reh'g*, Order No. 637-A, [Regs. Preambles] III F.E.R.C. STATS. & REGS. ¶ 31,099 (2000)[hereinafter Order No. 637-A]; *order denying reh'g*, Order No. 637-B, 92 F.E.R.C. ¶ 61,062 (2000), *appeals pending sub nom.*, Interstate Natural Gas Assoc. of America v. FERC, Nos. 98-1333, et. al. (D.C. Cir. July 22, 1998)[hereinafter collectively referred to as Order No. 637].

2. Order No. 637, *supra* note 1, at 31,296.

many implementation cases have concluded, several hotly contested pipeline compliance proceedings remain pending before the FERC. In particular, this section discusses some of the more rudimentary requirements set forth in the rulings issued thus far, and notes a few controversial requirements that have evolved through the Order No. 637 implementation process at the FERC.

#### A. *Scheduling Equality*

Order No. 637 requires pipelines to make revisions to their *pro forma* tariffs to include scheduling procedures so that capacity release transactions can be scheduled on a comparable basis to other pipeline services.<sup>3</sup> According to the Commission, placing released capacity on a level playing field with pipeline capacity will fuel a more competitive short-term market.<sup>4</sup> Therefore, new section 284.12(c)(1)(ii) provides that replacement shippers must be able to submit a nomination at the earliest available nomination opportunity after the acquisition of released capacity, and, if the pipeline requires the replacement shipper to execute a contract, the contract must be issued within one hour after the pipeline has been notified of the release.<sup>5</sup> As explained by the FERC, the new rule "will enable shippers to acquire released capacity at any of the nomination or intra-day nomination times, and nominate gas coincident with their acquisition of capacity."<sup>6</sup>

To date, the FERC's decisions in the individual pipeline implementation cases addressing scheduling equality have been fairly consistent across the board and have strictly adhered to the FERC's threshold requirement that nothing (including contracting requirements) should impede the ability of a replacement shipper to submit a nomination at the earliest available opportunity. However, in *Colorado Interstate Gas Co. (CIG)*, the FERC made an important distinction between prearranged deals not subject to bid and biddable releases for purposes of complying with the new scheduling equality regulation.<sup>7</sup> First, the Commission clarified that with respect to prearranged deals not subject to bid, releasing shippers should be able to inform the pipeline of the deals at any of the four nomination opportunities and the replacement shippers should be able to submit a nomination at the time the pipeline is informed of the release.<sup>8</sup> Therefore, contracts for prearranged deals not subject to bid must be tendered within

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3. Order No. 637, *supra* note 1, at 31,296.

4. *Id.* at 31,297.

5. 18 C.F.R. § 284.12(c)(1)(ii) (2001). To streamline the awarding and contracting process in light of the new scheduling equality regulation, the Commission suggested that pipelines utilize a pre-approval process, including a prior determination of creditworthiness for potential replacement shippers, to ensure that nothing would interfere with the ability of a replacement shipper to submit a nomination at the first available opportunity. Order No. 637, *supra* note 1, at 31,297-98.

6. Order No. 637, *supra* note 1, at 31,297.

7. 95 F.E.R.C. ¶ 61,321 (2001).

8. *Id.* at 62,112.

one hour of the time the pipeline has been notified of the prearranged deal. Second, for biddable releases, nominations should be allowed coincident with awards of capacity and contracts must be tendered within one hour of the time the pipeline has awarded that capacity.<sup>9</sup>

In *Iroquois Gas Transmission System, Inc.*, the pipeline proposed language that would prohibit a prearranged deal shipper from submitting a nomination until the next nomination cycle after a contract was issued.<sup>10</sup> The FERC rejected the proposed language and, consistent with its decision in *CIG*, held that Iroquois must allow a prearranged deal replacement shipper to submit a nomination coincident with the notification of the capacity release deal.<sup>11</sup> Likewise, in *Kinder Morgan Interstate Gas Transmission L.L.C.*, the Commission concluded that the pipeline's proposed language with respect to prearranged deals and biddable releases requiring a "waiting period" (between notification of the release and nominations) prior to nomination was inconsistent with Order No. 637 because it inhibited a replacement shipper's ability to make full use of the all nomination opportunities throughout the day.<sup>12</sup>

Finally, Panhandle Eastern Pipe Line Corporation (Panhandle) and the majority of its shippers reached a settlement on all Order No. 637 requirements, including scheduling equality.<sup>13</sup> As part of the settlement, Panhandle proposed to issue and to execute an Addendum to the replacement shipper's capacity release service agreement when the releasing shipper's service agreement is assigned to the replacement shipper. Panhandle proposed to issue the Addendum within one hour of the posting of a release and, provided all information is available and correct, execute the Addendum within that same hour. According to Panhandle's proposal, once the Addendum is executed, Panhandle would then allow the replacement shipper to submit a nomination. Although Panhandle and its shippers agreed to this process, the Commission rejected Panhandle's Addendum requirement. According to the FERC, Order No. 637 is clear that the contracting requirement not inhibit the ability of a replacement shipper to submit a nomination at the earliest availability opportunity.<sup>14</sup>

#### B. Segmentation And Flexible Point Rights

New section 284.7(d) requires that interstate pipelines permit firm shippers to subdivide their capacity into segments for their own use or for the purpose of releasing a segment(s) to replacement shippers to the extent such segmentation is operationally feasible on the pipeline.<sup>15</sup> In addi-

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9. 95 F.E.R.C. ¶ 61,321.

10. *Iroquois*, 97 F.E.R.C. ¶ 61,164 (2001).

11. *Id.* at 61,735. Also, in accordance with *CIG*, the Commission held that Iroquois must allow biddable releases to be nominated upon award by the pipeline. 97 F.E.R.C. at 61,735-36.

12. *Kinder Morgan*, 97 F.E.R.C. ¶ 61,062, at 61,334-35 (2001).

13. 97 F.E.R.C. ¶ 61,046 (2001).

14. *Id.* at 61,260-61.

15. 18 C.F.R. § 284.7(d) (2001). Previously, in Order No. 636, the Commission endorsed seg-

tion, Order No. 637 acknowledged the important role that flexible point rights,<sup>16</sup> together with segmentation, play in fostering efficient competition in the marketplace – both between shippers releasing capacity and the pipeline, as well as between releasing shippers.<sup>17</sup> The FERC concluded that the interplay between segmentation and flexible point rights would create more alternatives for shippers to obtain capacity to the benefit all shippers, especially captive customers.<sup>18</sup> Moreover, Order No. 637-A required pipelines to consider how the issues of overlapping capacity segments (including forwardhauls and backhauls to points within a transportation path), and the relationship between segmentation and primary point rights, point discounts, and main line priority at secondary points “within the path,” would be addressed in their tariffs.<sup>19</sup>

Although the Commission’s segmentation and flexible point right policies were previously endorsed in Order No. 636,<sup>20</sup> these compliance issues have proven to be controversial. For instance, several major interstate pipelines that did not previously permit segmentation submitted compliance filings alleging that segmentation would not be feasible on their systems due to operational conditions<sup>21</sup> while other pipelines that had some form of segmentation hesitated to expand their existing policies to provide additional rights, such as allowing shippers to nominate outside their transportation paths that were released or retained.<sup>22</sup>

The Commission provided additional guidance in several of its orders on these implementation issues and clarified the types of “operational” concerns that will render segmentation infeasible on a pipeline. For ex-

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mentation but did not include its segmentation policy in the regulations. Because segmentation was not being consistently applied across the interstate grid, Order No. 637 codified the Commission’s segmentation policy and required pipelines to allow shippers to segment their firm capacity or, at a minimum, demonstrate why segmentation was not operationally feasible. Order No. 637, *supra* note 1, at 31,301.

16. For purposes of Order No. 637, flexible point rights refers to the ability of a firm shipper to change receipt or delivery points so that they can receive and deliver gas to any point within the firm capacity rights for which they pay.

17. Order No. 637, *supra* note 1, at 31,300-01. Order No. 637 did not promulgate a generally applicable regulation for flexible point rights but recognized that this issue would be more appropriately handled on a pipeline-by-pipeline basis in the individual implementation cases. *Id.* at 31,301.

18. Order No. 657, *supra* note 1, at 31,301.

19. Order No. 637-A, *supra* note 1, at 31,591-98.

20. Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, and Regulation of Natural Gas Pipelines After Wellhead Decontrol*, [Reg. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 30,939, *order on reh'g*, Order No. 636-A, [Reg. Preambles 1991-1996] F.E.R.C. STATS. & REGS. ¶ 30,950, *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272 (1992), *aff'd in part and remanded in part*, United Distribution Cos. v. F.E.R.C., 88 F.3d 1105 (D.C. Cir. 1996), *cert. denied*, Associated Gas Distributors 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), *appeal docketed sub nom.*, Interstate Natural Gas Assoc. of Am. v. FERC., Docket No. 98-1333 (D.C. Cir. July 22, 1998).

21. See e.g. Order No. 637 Compliance Filing, Explanation of Compliance Measures, *Dominion Transmission, Inc.*, F.E.R.C. Docket No. RP00-344-000, at 3-4 (June 15, 2000); Compliance Filing, *Columbia Gas Transmission Corp.*, F.E.R.C. Docket No. RP00-327-000, at 22-33 (June 15, 2000).

22. *Iroquois*, 97 F.E.R.C. ¶ 61,164, at 61,736-37.

ample, in *Pauite Pipeline Co.*, the FERC agreed that segmentation was not “operationally feasible” at this time, because the pipeline is “a small, one-directional pipeline of simple configuration with supplies entering its system from a single pipeline interconnection with Northwest.”<sup>23</sup> Citing the same reasons, the FERC also found segmentation to be operationally infeasible in *Gulf States Transmission Corp.*, reasoning that “[b]ecause there is only one delivery point, there is no way for two transactions to simultaneously occur using different receipt and delivery points, as required for segmentation.”<sup>24</sup> However, with other pipelines, the FERC rejected claims of operational infeasibility. For example, the FERC rejected MIGC, Inc.’s assertions that segmentation is not: (1) operationally feasible given the configuration of its system (e.g., its limited length (less than 175 miles), the majority of its receipts are delivered at the system’s southern-most terminus, and lack of significant on system market); or (2) particularly desirable for its shippers.<sup>25</sup> The FERC emphasized that failure to allow segmentation would be permitted only when segmentation is operationally infeasible – the fact that a pipeline does not believe that shippers will use segmentation is insufficient to justify denying shippers the opportunity to segment the capacity they have contracted for to gain competitive benefits.<sup>26</sup>

One of the more original segmentation proposals arose out Dominion Transmission, Inc.’s (DTI) Order No. 637 implementation proceeding. In its initial compliance filing, DTI argued that “physical” segmentation was not operationally feasible given its “reticulated” system. Therefore, by way of a settlement with its shippers, DTI proposed to implement “virtual” segmentation.<sup>27</sup> The Commission, agreeing that DTI’s system was reticulated but noting that its reticulated nature alone would not be a reason to refuse to provide the ability to segment, approved DTI’s virtual segmentation. In particular, the FERC concluded that DTI’s proposal “satisfies the requirements of Order No. 637 by allowing segmentation to the extent fea-

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23. 96 F.E.R.C. ¶ 61,167, at 61,749 (2001).

24. 96 F.E.R.C. ¶ 61,159, at 61,693 (2001).

25. *MIGC, Inc.*, 96 F.E.R.C. ¶ 61,042, at 61,104 (2001).

26. *Id.* See also *High Island Offshore System, L.L.C.*, 97 F.E.R.C. ¶ 61,156, at 61,686 (2001) (the FERC rejected HIOS’ claims that there has been little shipper interest in segmentation because of the location and structure of the pipeline and required HIOS to permit segmentation on its system where operationally feasible); *Ozark Gas Transmission L.L.C.*, 96 F.E.R.C. ¶ 61,160, at 61,699-70 (2001) (the FERC required segmentation on Ozark to the extent operationally feasible and rejected Ozark’s assertions that the fact that it has only one rate zone and its configuration renders segmentation infeasible).

27. *Dominion Transmission, Inc.*, 95 F.E.R.C. ¶ 61,316, at 62,082 (2001). Under DTI’s virtual “Market Center Segmentation” proposal, the system would be divided into two parts – the access segment and the delivery segments – each containing a virtual Market Center Point (South Point and North Point). A shipper could segment its capacity between its receipt point(s) and South Point and/or North Point through either the nomination process or through the capacity release provisions of DTI’s tariff. DTI agreed to maintain on its bulletin board a list of its receipt points with a designation of whether each point provides access on a primary basis to North Point or South Point for purposes of Market Center Segmentation. *Id.*

sible, while preserving the existing flexibility of DTI.”<sup>28</sup>

Moreover, the Commission confirmed that all shippers (releasing and replacement) should be permitted to move freely to secondary points within and outside their transportation paths provided their nominations do not exceed the underlying contract demand.<sup>29</sup> This includes permitting forwardhauls and backhauls to the same delivery point as long as mainline contract demand is not exceeded and it is operationally possible for the pipeline to handle the deliveries at the point.<sup>30</sup>

### C. Imbalance Management Services, OFOs And Penalties

In Order No. 637, the Commission recognized that the current system of OFOs and penalties does not efficiently promote system reliability and, in fact, stricter imbalance tolerance levels and higher penalties often operate to limit and distort market forces.<sup>31</sup> Moreover, the Commission concluded that the presence of arbitrage on some pipeline systems indicates that shippers might be using the existing penalty system in such a way as to gain increased flexibility on the pipeline.<sup>32</sup> Therefore, the FERC promulgated a policy that moved away from the use of negative incentives (such as penalties and OFOs) toward one that encouraged the development of positive incentives (such as imbalance management services).<sup>33</sup> This new “service-oriented” approach would allow shippers to gain additional flexibility and, at the same time, maintain pipeline reliability.<sup>34</sup> The Commission’s orders issued in the individual pipeline implementation cases echo its commitment to using non-penalty mechanisms to solve and prevent the occurrence of pipeline operational/reliability concerns.

#### 1. Imbalance Management Services

According to the FERC, “the availability of imbalance management services is critical for providing many shippers with the flexibility they need to avoid or correct imbalances, which in turn obviates the need for pipelines to impose OFOs and penalties.”<sup>35</sup> Therefore, the new section 284.12(c)(2)(iii) requires pipelines, to the extent operationally practicable, to provide imbalance management services, such as park and loan services.<sup>36</sup> However, Order No. 637 also requires pipelines to implement imbalance netting and trading protocols as a pre-requisite to providing new

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28. 95 F.E.R.C. ¶ 61,316, at 62,083.

29. *Iroquois*, 97 F.E.R.C. ¶ 61,164, at 61,737(2001).

30. *Id.*

31. Order No. 637, *supra* note 1, at 31,307; Order No. 637-A, *supra* note 1, at 31,598.

32. Order No. 637-A, *supra* note 1, at 31,598.

33. Order No. 637, *supra* note 1, at 31,309.

34. *Id.*

35. Order No. 637, *supra* note 1, at 31,311.

36. 18 C.F.R. § 284.12(c)(2)(iii) (2001); Order No. 637, *supra* note 1, at 31,310.

imbalance management services.<sup>37</sup> In addition, the FERC's new policy requires that pipelines must not give undue preference to their own balancing services over third party services.<sup>38</sup> Prior to Order No. 637, many pipelines already provided an array of imbalance management tools, including parking and lending services and imbalance netting and trading. Therefore, the Commission's review of imbalance management services in the implementation cases focused primarily on the requirement that shippers be able to access third party services to curb and cure imbalances. Nonetheless, the Commission did approve a few new imbalance management services, such as Panhandle's proposed Rate Schedule DVS (Delivery Variance Service) that would allow a shipper to contract and pay for a high scheduling tolerance level to stay in balance.<sup>39</sup>

With respect to third party providers of imbalance management services, the FERC carefully monitored pipeline filings to ensure that there was nothing in any pipeline tariff that would unduly discriminate against or restrict shippers from accessing third party balancing services.<sup>40</sup> For example, in *Kinder Morgan*, the pipeline proposed several restrictions on the use of third party services, which the FERC rejected. Namely, the FERC rejected Kinder Morgan's proposal that would prohibit a third party from providing a service which involved the resale and/or repackaging of an existing balancing service offered by Kinder Morgan if the resale and/or repackaging would create a greater obligation on Kinder Morgan or other shippers than existed prior to the resale and/or repackaging.<sup>41</sup> The FERC held that Kinder Morgan should adopt (or be required to explain why it should not adopt) an approach that requires non-discriminatory access to third party services provided those services comply with the Gas Industry Standards Board (GISB) requirements and do not adversely affect Kinder Morgan's operations.<sup>42</sup> The FERC also rejected Kinder Morgan's proposal to require that, in cases of default: (1) third parties fully indemnify themselves; and (2) shippers are penalized 200% of the rate for park and loan.<sup>43</sup> Ultimately, the FERC reasoned that since the park and loan service is interruptible and only available when there is capacity, a shipper should only be charged 100% the park and loan rate.<sup>44</sup>

## 2. Operational Flow Orders (OFOs)

Order No. 637 requires a pipeline to take all reasonable actions to minimize OFOs or other measures taken to respond to adverse opera-

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37. Order No. 637, *supra* note 1, at 31,311.

38. *Id.* at 31,310.

39. *Panhandle*, 97 F.E.R.C. ¶ 61,046, at 61,268 (2001).

40. *See e.g.*, *CIG*, 95 F.E.R.C. ¶ 61,321, at 62,122-23 (2001); *Trailblazer Pipeline Co.*, 97 F.E.R.C. ¶ 61,056, at 61,304(2001).

41. *Kinder Morgan*, 97 F.E.R.C. ¶ 61,321, at 61,340 (2001).

42. *Id.*

43. 97 F.E.R.C. ¶ 61, 321, at 61,340-41.

44. *Id.*

tional events on its system.<sup>45</sup> In particular, the FERC requires pipelines to: (1) state clear standards, based on objective operational conditions, for the duration of an OFO; (2) post information about the status of operational variables that determine the duration of an OFO; (3) state the steps and order of operational remedies that will be followed before an OFO is issued; (4) establish standards for levels of severity of OFOs to correspond to degrees of system emergencies the pipeline may confront; and (5) establish reporting requirements that provide information about the factors that caused the OFO to be issued and then lifted.<sup>46</sup> The FERC's decisions in the implementation cases addressing OFOs emphasize the necessity for the pipeline to provide to shippers greater detail about the types of operational issues that will result in an OFO – both prior to and after the issuance of an OFO – in a timely fashion.<sup>47</sup>

In the orders issued thus far, the FERC has also expressed its concern that the OFO provisions be narrowly designed to deter only conduct that is actually harmful to the pipeline system. To meet this objective, the FERC has approved pipeline proposals that suggest the use of a type of pre-OFO alert to be given to shippers when the pipeline is headed for system stress. Specifically, Transcontinental Gas Pipe Line Corporation (Transco) proposed “Operational Controls” that could be issued prior to issuing an OFO. According to Transco, these provisions “are designed to curb the behavior of customers, provide flexibility to Transco, and to alleviate operating conditions that could lead to the issuances of an OFO.”<sup>48</sup> The Commission agreed that the “Operational Controls” respond to the new OFO policy and “provide assurance that if Transco must issue an OFO, it will have a limited application and consequence.”<sup>49</sup> Similarly, Kinder Morgan proposed and the Commission approved, its use of new “Directional Notices” and “Advisory Actions” that would be issued prior to an OFO. The FERC recognized that this tiered approach might allow Kinder Morgan to avoid the necessity of having to issue an OFO and, in turn, shippers might not be faced with an OFO penalty.<sup>50</sup>

### 3. Penalties

In Order No. 637, the Commission determined that shippers are using the penalty system to indirectly gain needed flexibility and therefore the

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45. 18 C.F.R. § 284.12(c)(2)(iv) (2001).

46. Order No. 637, *supra* note 1, at 31,312-13.

47. *Iroquois*, 97 F.E.R.C. ¶ 61,164, at 61,750 (2001) (requiring Iroquois to provide more detailed information that will be posted in advance of an issuance of an OFO); *ANR Storage Co.*, 96 F.E.R.C. ¶ 61,162, at 61,709(2001)(ordering ANR to provide to provide shippers with updated information concerning the status of operational variables related to OFOs as soon as it is available).

48. *Transcontinental Gas Pipe Line Corp. (Transco)*, 96 F.E.R.C. ¶ 61,352, at 62,314 (2001).

49. *Id.* at 62,316.

50. *Kinder Morgan*, 97 F.E.R.C. ¶ 61,062, at 61,342 (2001). *See also Trailblazer*, 97 F.E.R.C. ¶ 61,056, at 61,305-06 (2001)(Commission accepted Trailblazer's tiered operational plans and associated penalties, including “Advisory Action” procedures and penalties, as consistent with Order No. 637's objectives).



Commission shifted its policy to require that penalties only be imposed when needed to protect system integrity.<sup>51</sup> In short, the FERC confirmed the continued use of penalties, but narrowly directed the application of these penalties to situations jeopardizing system reliability.<sup>52</sup> As a result, new section 284.12(c)(2)(v) requires that pipeline penalty regimes<sup>53</sup> be based on three principles: (1) transportation penalties may be included in the tariff only to the extent necessary to prevent the impairment of reliable service; (2) shippers must be credited all penalty revenues net of costs;<sup>54</sup> and (3) shippers must be provided as much timely information as possible about the imbalance and overrun status of each shipper and the imbalance of the pipeline system generally.<sup>55</sup>

Many of the Commission's decisions in the implementation cases illustrate its commitment to require pipeline penalties to bear a relationship to the harm shipper conduct could likely cause to a particular pipeline system. For example, in *CIG*, the pipeline charged an authorized overrun penalty (the maximum IT rate) and an unauthorized penalty for overruns that exceeded a 3% tolerance (starting at two times the monthly spot index price). Although the Commission accepted *CIG*'s use of an authorized charge and unauthorized overrun penalty, the Commission required *CIG* to revise its tariff to provide that the unauthorized overrun penalty would apply only during critical periods. According to the Commission:

[d]uring non-critical periods, a shipper who scheduled overrun service would presumably receive the requested service. Assessing a penalty that is many times higher than the authorized rate for failure to request service is excessive when the conduct would not likely cause harm to the system. Thus, *CIG*'s unauthorized overrun penalties which are substantially higher than the authorized overrun rate are justified only in critical periods when the system is constrained.<sup>56</sup>

The Commission reached the same conclusion in *Trailblazer* when it rejected the pipeline's \$10/dt unauthorized overrun penalty because *Trailblazer* had not adequately justified why such a substantial overrun penalty should apply to overruns on non-critical days.<sup>57</sup>

Although not required by Order No. 637, the Commission approved proposals by pipelines to change penalty pricing to an index price rather than a flat fee in an effort to have the penalty amount more accurately reflect what is happening in the market. For example, *Panhandle* and its shippers agreed in settlement to change the unauthorized overrun penalty

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51. Order No. 637, *supra* note 1, at 31,308.

52. Order No. 637-A, *supra* note 1, at 31,607.

53. This includes tariff provisions related to overrun and OFO penalties, as well as cash-out and other imbalance and scheduling penalties.

54. According to the Commission, allowing pipelines to retain revenues from penalties would "offer an incentive for pipelines to propose or implement inappropriate penalties and OFOs that can hinder efficiency and competition." Order No. 637, *supra* note 1, at 31,315.

55. 18 C.F.R. § 284.12(c)(2)(v) (2001).

56. *CIG*, 95 F.E.R.C. ¶ 61,321, at 62,124-25 (2001).

57. *Trailblazer*, 97 F.E.R.C. ¶ 61,056, at 61,306 (2001).

level from \$15.00/dt to two times the greater of the highest daily price published in *Gas Daily*, Daily Price Survey, Citygates – Chicago LDCs or Citygates – Mich.-Mich Con for the day.<sup>58</sup>

Furthermore, the Commission also approved changes to cash-out mechanisms that were proposed by pipelines in order to alleviate the gaming that was purportedly occurring on numerous pipeline systems. In *Transco*, the Commission approved Transco's proposal to add a "fifth week" to the calculation of the cash-out price.<sup>59</sup> The Commission agreed that "adding the fifth week will address the arbitrage opportunities claimed by Transco that might arise at the end of the month" because Transco's customers will be uncertain of the Reference Spot Prices before the month in which they are shipping gas ends and, because of the cash-out price uncertainty, will be less likely to engage in arbitrage.<sup>60</sup>

Finally, with respect to crediting penalty revenues, the FERC held in several decisions, including *Kinder Morgan*, that all non-offending shippers, both firm and interruptible, should receive pro rata shares of penalty revenues, since both are potentially subject to penalties.<sup>61</sup> Moreover, in *Trailblazer*, the FERC ordered that non-offending shipper status should be determined on a monthly, as opposed to annual, basis.<sup>62</sup>

#### D. Rebuttable Presumption For Discounts And Partial Day Recalls

Two other important compliance requirements that arguably were not squarely addressed by Order No. 637 have evolved through the compliance filing process – the portability of discounts and intra-day recall rights. First, in Order No. 637-A, the Commission stated that pipelines should address in their individual compliance filings the interaction between segmentation and selective discounting when segmentation occurs within the path of a discount shipper's transportation contract.<sup>63</sup> In particular, the Commission was concerned that segmentation would be restricted if pipelines could automatically refuse to allow a discount at a particular point in a segmented transaction to be used by a replacement shipper at alternate points within the released segment.

In *CIG*, the first pipeline implementation case to address discounts, the FERC concluded that, in light of its goal to increase competition, it must refine its selective discount policy. Therefore, in order to place released and pipeline capacity on equal footing, the FERC announced a "re-

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58. Tariff Filing to Implement Order No. 637 Settlement, Sheet No. 272, *Panhandle Eastern Pipeline Corp.*, F.E.R.C. Docket No. RP00-395-003, at § 12.6(a) (Dec. 28, 2001).

59. Under Transco's "fifth week" proposal, imbalances would be cashed out at the Reference Spot Price in each zone that includes the use of prices reported for each week of the month in which the imbalance occurred, as well as the prices from the first week of the month following the month in which the imbalances occurred. *Transco*, 96 F.E.R.C. ¶ 61,352, at 62,311 (2001).

60. *Transco*, 96 F.E.R.C. ¶ 61,352, at 62,313.

61. *Kinder Morgan*, 97 F.E.R.C. ¶ 61,062, at 61,343 (2001).

62. *Trailblazer*, 97 F.E.R.C. ¶ 81,056, at 61,307(2001).

63. Order No. 637-A, *supra* note 1, at 31,595.

buttable presumption” test to apply to discounts. Generally speaking, the new policy adopts a rebuttable presumption that a shipper segmenting, releasing or utilizing specific points on a secondary basis will receive a discount at such points if a pipeline is already granting discounts to the points under other firm or interruptible service agreements.<sup>64</sup> The pipeline can rebut the presumption by demonstrating that the segmented or secondary point transaction is not similarly situated to the shippers receiving discounts from the pipeline.<sup>65</sup> The FERC placed the burden on the pipelines to justify a denial of a discount because it was concerned that pipelines may not have the same incentive to offer discounts to segmented transactions or to secondary points that compete directly with the sale of their pipeline capacity.

The mechanics of the rebuttable presumption test have been further refined as the FERC has issued more orders in the implementation proceedings addressing discounting. For example, in order to establish a uniform method for processing requests to retain discounts and comport with the Commission’s scheduling equality requirements, the FERC ordered that pipelines must evaluate shipper requests to retain discounts within two hours.<sup>66</sup> Furthermore, the FERC clarified that its discounting policy applies to all capacity – not just segmented capacity.<sup>67</sup>

Second, although its recent Notice of Proposed Rulemaking (NOPR) addressing partial day recalls is still pending,<sup>68</sup> the Commission approved in at least one implementation case (*DTI*), tariff provisions allowing intra-day recalls of released capacity. Under the settlement reached between *DTI* and its shippers, the pipeline requested waiver of GISB Standard 5.3.7, Version 1.4 (which prohibits partial day recalls) in order to allow releasing shippers that specifically provide notice in advance, to recall capacity on a partial-day basis. Over the objections of only one party, the Commission granted the waiver and approved the provisions allowing partial day recalls. The Commission concluded that the capacity release regulations allow releasing shippers to release their capacity without restriction on the terms or conditions of the release – including recalls.<sup>69</sup> However, regarding intra-day recalls, it is likely that further Commission action will be handled in the context of the NOPR rather than the Order No. 637 implementation cases.

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64. *CIG*, 95 F.E.R.C. ¶ 61,321, at 62,121 (2001).

65. *Id.*

66. *Dominion Transmission, Inc. (DTI)*, 96 F.E.R.C. ¶ 61,270, at 62,029 (2001). See also *Kinder Morgan*, 97 F.E.R.C. ¶ 61,062, at 61,338-39 (2001).

67. *National Fuel Gas Supply Corp.*, 97 F.E.R.C. ¶ 61,104, at 61,548-49 (2001).

68. Notice of Proposed Rulemaking, *Standards For Business Practices of Interstate Natural Gas Pipelines*, 97 F.E.R.C. ¶ 61,047 (2001).

69. *DTI*, 95 F.E.R.C. ¶ 61,270, at 62,082 (2001).

## II. TEXAS EASTERN POLICY REGARDING PIPELINE ABILITY TO HOLD UPSTREAM CAPACITY

In Order No. 636, the Commission required interstate pipelines to unbundle their sales and transportation functions and to assign their upstream capacity to their firm shippers. Subsequently, the Commission issued a declaratory order in *Texas Eastern Corp.*<sup>70</sup> holding that although Order No. 636 did not create a *per se* rule prohibiting pipelines from acquiring capacity on another pipeline (offsystem capacity), pipelines must obtain the Commission's approval before doing so on a case-by-case basis. In *Colorado Interstate Gas Co. v. FERC*,<sup>71</sup> the court remanded the Commission's pre-approval requirement for further proceedings after finding that the Commission had not adequately explained its decision to require pipelines and no other shipper to receive advance approval before acquiring capacity on another pipeline.

On December 14, 2000, the Commission issued an order on remand reversing its *Texas Eastern* policy.<sup>72</sup> The Commission determined that its regulations and policy have evolved to the extent that it was no longer necessary to require pipelines to obtain Commission approval before contracting for offsystem capacity. To mitigate against adverse rate impacts, the Commission established an at-risk condition for pipelines holding offsystem capacity. In addition, the Commission found that its concerns regarding tying arrangements, undue discrimination and other actions that would limit customer choice as a result of a pipeline acquiring offsystem capacity can be resolved by enforcement of the open access regulations and the Order No. 637 reporting requirements. The Commission also noted that market participants can file a complaint for any alleged abuses resulting from a pipeline holding offsystem capacity.

## III. ORDER REMOVING OBSTACLES TO INCREASED NATURAL GAS SUPPLY IN THE WEST

In an effort to address severe energy shortages in the West, on March 14, 2001, the Commission issued an *Order Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States and Requesting Comments on Further Action to Increase Energy Supply and Decrease Energy Consumption*.<sup>73</sup> The Commission discussed internal staffing changes it made to expedite the processing of applications for certificates to construct new interstate pipeline capacity and sought comment on the following three proposals:

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70. 74 F.E.R.C. ¶ 61,074 (1996); *reh'g denied*, 78 F.E.R.C. ¶ 61,277 (1997).

71. 146 F.3d 889 (D.C. Cir. 1998).

72. 93 F.E.R.C. ¶ 61,273 (2000); *reh'g denied*, 94 F.E.R.C. ¶ 61,139 (2001); *order denying clarification and reh'g*, 95 F.E.R.C. ¶ 61,056 (2001).

73. Order Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States and Requesting Comments on Further Actions to Increase Energy Supply and Decrease Energy Consumption, 94 F.E.R.C. ¶ 61,272 (2001)[hereinafter First Order Removing Generation Obstacles].

1) waiving the blanket certificate regulations to increase the dollar limitations for facilities under automatic authorization to \$10 million and for prior notice authorizations to \$30 million; 2) offering blanket certificates for construction or acquisition and operation of portable compressor stations to enhance pipeline capacity to California; and 3) offering rate incentives to expedite construction of projects that will make additional capacity available [during the upcoming] summer on constrained pipeline systems.<sup>74</sup>

The Commission also sought comment on whether or not to allow rolled-in rates for new facilities constructed under blanket authorizations exceeding \$20.6 million.<sup>75</sup>

The Commission also expressed concern that its actions to expedite the availability of new interstate gas transportation capacity were constrained by the ability of the states to deliver gas downstream of the interstate pipeline.<sup>76</sup> In an effort to rectify this potential bottleneck, the Commission requested that pipelines coordinate with local distribution companies, public utilities, and state officials to ensure that there would be adequate take-away capacity to accommodate the resulting increase in interstate capacity.<sup>77</sup>

On May 16, 2001 the Commission issued a further order responding to comments it received after the initial Order was released. Many commenters emphasized the need for the Commission to coordinate with other state and federal agencies to streamline and expedite the approval process for new pipeline capacity. One commenter further suggested that the Commission use its authority under section 17 of the Natural Gas Act to convene joint boards to facilitate pipeline enhancements.<sup>78</sup> In the May 16th Order, the Commission reiterated its commitment to improving and accelerating the certification process but declined to exercise its authority to convene joint boards to facilitate enhancements.<sup>79</sup>

In the May 16 Order, the Commission also decided to waive its existing regulations, on a temporary basis, for purposes of raising blanket certificate limits to \$10 million for automatic authorizations and to \$30 million for prior notice authorizations for all pipelines that deliver gas in the Western Systems Coordinating Council.<sup>80</sup> This waiver only applies to projects that will be built and in service by April 30, 2002.<sup>81</sup> The Commission clearly noted that the temporary waiver did not override its prohibition against pipelines segmenting projects to meet the automatic or prior notice

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74. *Id.* at 61,975.

75. First Order Removing Generation Obstacles, *supra* note 73, at 61,975.

76. *Id.*

77. First Order Removing Generation Obstacles, *supra* note 73, at 61,975.

78. Further Order Removing Obstacles to Increased Electric Generation and Natural Gas Supply in the Western United States and Requesting Comments on Further Actions to Increase Energy Supply and Decrease Energy Consumption, 95 F.E.R.C. ¶ 61,225, at 61,774 (2001) [hereinafter Second Order Removing Generation Obstacles].

79. *Id.*

80. Second Order Removing Generation Obstacles, *supra* note 78, at 61,775.

81. *Id.*

cost limitations.<sup>82</sup>

In addition, the Commission temporarily waived its regulations to expand the definition of eligible facilities governed by sections 157.202(b)(2)(ii)(A), (B), (C) and (F) of the Commission's regulations.<sup>83</sup> This waiver makes the following facilities eligible: "a main line, an extension of a mainline, a facility, including compression and looping, that alters the capacity of a main line, and temporary compression that raises the capacity of a mainline . . . ."<sup>84</sup> In an effort to monitor the effectiveness of these measures, the Commission required pipelines that were granted waivers to Part 157 regulations to file a report by June 1, 2002 outlining the details of all of the projects they had accepted as a result of the expanded blanket authorizations.<sup>85</sup>

Finally, the Commission declined to adopt additional rate incentives to encourage the construction of projects that would have made additional capacity available during the summer of 2001. In proposing rate incentives, the Commission attempted to strike a balance between the need to increase capacity, the desire to protect consumers from having to subsidize the rate incentives, and the desire to ensure that the proper price signals were sent to the market.<sup>86</sup> Although some commenters supported the Commission's proposal to offer rate incentives, the Commission found that no party in support of rate incentives submitted a viable proposal that would make additional capacity available by the summer of 2001.<sup>87</sup>

The Commission has carried out its goals of expediting the construction of new pipeline capacity in several recent decisions approving certificate applications. For example, in its decision provisionally approving the certificate of North Baja Pipeline, the Commission cited its commitment to increasing pipeline capacity as part of the rationale for its preliminary determination of approval.<sup>88</sup> In its Order Issuing Certificate and Approving Abandonment for Transwestern Pipeline Company, one of the factors the Commission used to evaluate Transwestern's application was Transwestern's ability to contribute to the alleviation of the energy crisis.<sup>89</sup> On July 26, 2001, the Commission issued a certificate to Kern River Gas Transmission to construct and operate facilities to provide long-term firm transportation from Wyoming to California.<sup>90</sup> Again, the Commission cited the energy crisis in the West as justification for its approval of the certificate.<sup>91</sup>

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82. Second Order Removing Generation Obstacles, *supra* note 78, at 61,775.

83. *Id.* at 61,776.

84. Second Order Removing Generation Obstacles, *supra* note 78, at 61,776.

85. *Id.*

86. Second Order Removing Generation Obstacles, *supra* note 78, at 61,776.

87. *Id.* at 61,777.

88. *North Baja Pipeline L.L.C.*, 95 F.E.R.C. ¶ 61,259, at 61,916 (2001).

89. Order Issuing Certificate and Approving Abandonment, *Transwestern Pipeline Company*, 96 F.E.R.C. ¶ 61,078, at 61,339 (2001).

90. Order Issuing Certificate, *Kern River Gas Transmission Company*, 96 F.E.R.C. ¶ 61,137 (2001).

91. *Id.* at 61,590.

On December 21, 2001, the Commission issued a certificate to the East Tennessee Natural Gas Company for the authority to abandon some pipeline facilities and to construct and operate replacement facilities to serve the Tennessee Valley Authority.<sup>92</sup> In this order, the Commission also maintained its commitment to expediting the Certificate process.<sup>93</sup>

#### IV. STANDARDS OF CONDUCT GOVERNING THE RELATIONSHIP BETWEEN INTERSTATE NATURAL GAS PIPELINES, ELECTRIC UTILITIES AND THEIR AFFILIATES

On September 27, 2001, the Commission issued a Notice of Proposed Rulemaking (NOPR) in Docket No. RM01-10, wherein the Commission is proposing new standards of conduct to apply to interstate natural gas pipelines and public utilities transmitting electric energy (collectively "transmission providers").<sup>94</sup> Interstate natural gas pipelines are subject to existing standards of conduct in 18 C.F.R. part 161, which govern their relationship with certain commonly controlled affiliates engaged in the sale of natural gas and that conduct transportation transactions with the pipeline affiliate. Public utilities that own, operate, or control facilities used for the transmission of electric energy in interstate commerce are subject to existing standards at 18 C.F.R. part 37.4, which govern their relationship with certain commonly controlled affiliates engaged in the sale for resale of electric energy in interstate commerce.

The NOPR proposes a new single set of standards of conduct that would replace these existing separate standards of conduct, and govern relationships of "transmission providers" with all of their "energy affiliates."<sup>95</sup> The new standards, like the existing standards, are intended to restrict the ability of transmission providers to give their gas marketing affiliates or wholesale electric merchant functions undue preferences over non-affiliated customers, and to ensure that affiliated and non-affiliated customers receive access to transmission provider services and related information on a non-discriminatory basis.

The proposed new standards are broader than the existing standards in several significant respects. The definition of "energy affiliates" results in the proposed standards governing "relationships between regulated transmission providers and all their energy affiliates, broadening the definition of an affiliate covered by the standards of conduct, from the more narrow definition in the existing regulations."<sup>96</sup> Proposed 18 C.F.R. section

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92. Order Issuing Certificate and Approving Abandonment, *East Tennessee Natural Gas Company*, 97 F.E.R.C. ¶ 61,361 (2001).

93. *Id.*

94. Notice of Proposed Rulemaking, *Standards of Conduct for Transmission Providers*, 66 Fed. Reg. 50,919 (2001) (to be codified at 18 C.F.R. pts. 37, 161, 250, 284, 358).

95. The Commission is not proposing to change or codify the electric codes of conduct governing power marketers or other affiliates with market-based rate authority. See e.g. *Heartland Energy Services, Inc.*, 68 F.E.R.C. ¶ 61,223, at 62,064-65 (1994).

96. 66 Fed. Reg. 50,919, at 50,920.

358.3(d) defines an “energy affiliate,” with whom the transmission provider’s relationship is governed or restricted by the proposed new standards, as

an affiliate of the transmission provider that: (1) [e]ngages in or is involved in transmission transactions; or (2) [m]anages or controls transmission capacity of a transmission provider; or (3) [b]uys, sells, trades or administers natural gas or electric energy; or (4) [e]ngages in financial transactions relating to the sale or transmission of natural gas or electric energy.<sup>97</sup>

In addition, the types of information, employees, and facilities that a transmission provider could provide or share with its energy affiliates have been further restricted by the proposed new standards. The proposed new standards would also add or revise posting requirements concerning the transfer of employees between energy affiliates, organization charts, and discounted transactions.

The NOPR also solicits comments on additional topics that may need to be addressed in additional rulemakings to limit transmission providers’ abilities to grant their affiliates undue preferences, including: (a) bidding activities by marketing affiliates for capacity on affiliated transmission providers; (b) limiting the amount of capacity an affiliate can hold on the transmission provider; (c) revising capacity allocation and interruptible bumping procedures; (d) prohibiting transmission providers from entering into profit-sharing agreements with affiliates and non-affiliates; (e) requiring the pipelines to disgorge any revenues paid by a marketing affiliate in excess of the pipeline’s opportunity costs; (f) requiring the geographic separation of transmission functions and affiliates; and (g) prohibiting affiliated power generators from connecting with affiliated pipelines.

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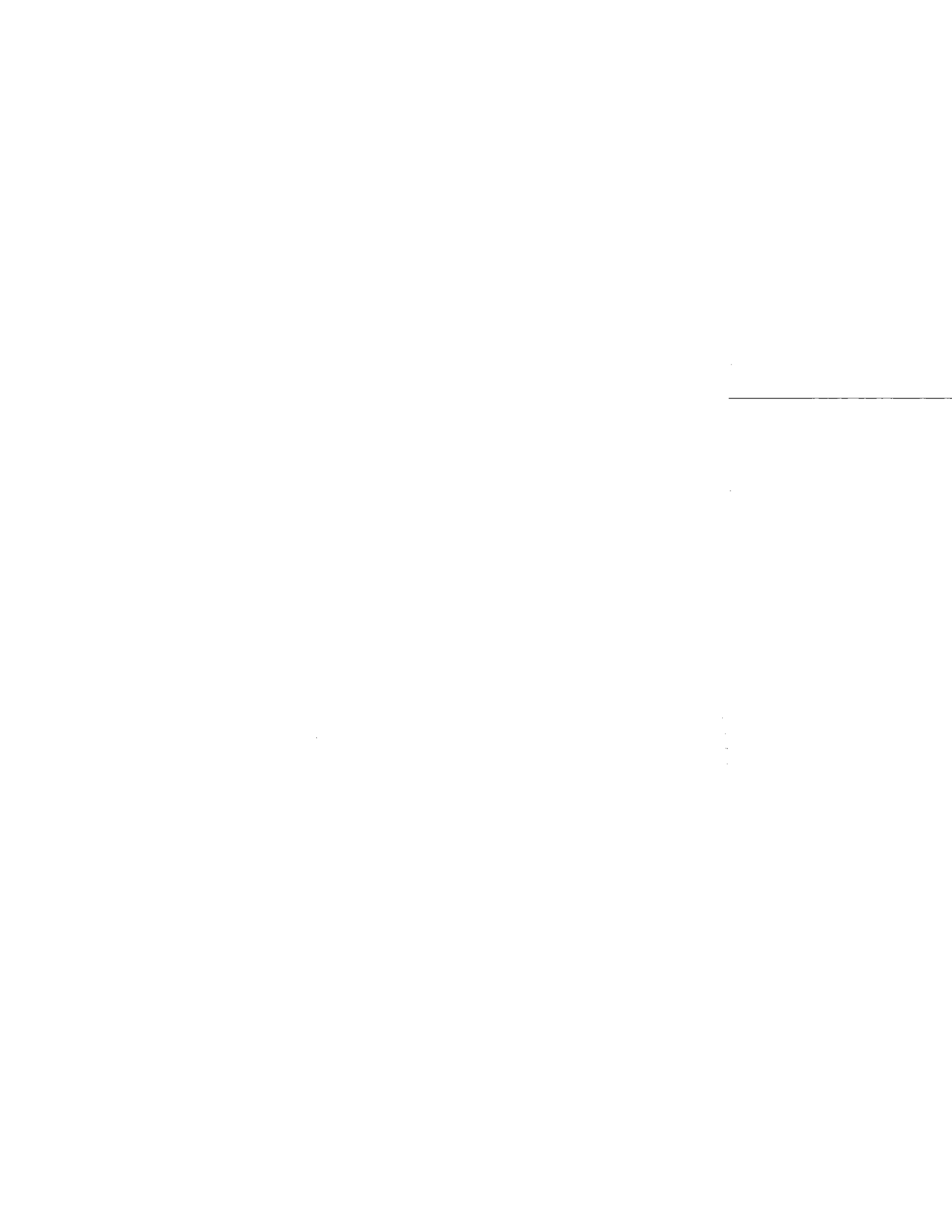
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