

LEXSEE 47 F.E.R.C. 61295

Interstate Natural Gas Pipeline Rate DesignBlack Marlin Pipeline CompanyChandeleur Pipeline CompanyCNG Transmission CorporationColumbia Gas Transmission CorporationColumbia Gulf Transmission CompanyEl Paso Natural Gas CompanyFlorida Gas Transmission CompanyHigh Island Offshore SystemInland Gas Company, Inc.Kentucky West Virginia Gas CompanyKN Energy, Inc.Midwestern Gas Transmission CompanyNational Fuel Gas Supply CorporationNorthern Border Pipeline CompanyNorthern Natural Gas CompanyNorthwest Pipeline CorporationPanhandle Eastern Pipe Line CompanyPaiute Pipeline CompanyPelican Interstate Gas SystemSea Robin Pipeline CompanyTennessee Gas Pipeline CompanyTexas Eastern Gas Transmission CorporationTranscontinental Gas Pipe Line CorporationTranswestern Pipeline CompanyTrunkline Gas CompanyU-T Offshore SystemWest Texas Gas, Inc.West Texas Gathering CompanyWilliams Natural Gas CompanyWilliston Basin Interstate Pipeline Company

Docket No. PL89-2-000;Docket No. RP89-75-000;Docket No. RP89-86-000;Docket No. RP88-211-000;Docket No. RP86-168-000;Docket No. RP86-167-000;Docket No. RP88-44-000;Docket No. RP89-50-000;Docket No. RP89-37-000;Docket No. RP89-65-000;Docket Nos. RP86-52-000 and RP89-146-000;Docket Nos. RP89-61-000, RP87-86-005, RP86-11-002, RP85-11-019 (Phase II), RP89-110-000, and RP89-111-000;Docket Nos. RP89-35-000 and RP89-36-000;Docket No. RP89-49-000;Docket No. RP89-33-000;Docket No. RP88-259-000;Docket No. RP88-47-000;Docket No. RP88-262-000;Docket No. RP88-227-000;Docket No. RP89-73-000;Docket No. RP88-181-000;Docket No. RP88-228-000;Docket No. RP88-67-000;Docket No. RP87-7-000;Docket No. RP89-48-000;Docket No. RP88-180-000;Docket No. RP89-38-000;Docket No. RP88-256-001;Docket No. RP89-67-000;Docket No. RP87-33-000;Docket Nos. RP88-197-000, RP88-236-000 and RP89-34-000

FEDERAL ENERGY REGULATORY COMMISSION - Commission

47 F.E.R.C. P61,295; 1989 FERC LEXIS 1350; 102 P.U.R.4th 405

Policy Statement Providing Guidance with Respect to the Designing of Rates

May 30, 1989

PANEL:

[**1] Before Commissioners: Martha O. Hesse, Chairman; Charles G. Stalon, Charles A. Trabandt, Elizabeth Anne Moler and Jerry J. Langdon.

OPINION:

[*62,051] I. PurposeIn 1985, the Commission adopted Order No. 436 n1 to launch a new era of open-access transportation by pipelines performing self-implementing transportation under either the Natural Gas Act n2 or the Natural Gas Policy Act (NGPA). n3 The Commission codified its new open-access transportation program in Part 284 of its regulations. n4 In Part 284, the Commission set forth its objectives and policies with respect to the designing of rates for a pipeline's open-access transportation services. As a result of its experience in designing transportation rates under the principles of Order No. 436, and in examining the design of the transportation component of sales rates, the Commission here states that the same goals and policies are equally applicable to both types of rates. The purpose of this order is to provide the administrative law judges (ALJs) and the participants (including the Commission staff) in the above-captioned proceedings with additional guidance on how to implement the Commission's rate objectives and policies under Part 284. [**2] n5 This policy statement will enable the participants to develop factual records upon which the ALJs, in the first instance, and the Commission on review can fashion comprehensive rate design schemes tailored to particular pipelines which will fulfill the intent of the NGPA that market forces play a "more significant role in determining the supply, the demand, and the price of natural gas," n6 and the mandate of the Natural Gas Act that a pipeline's rates must be just and reasonable and must not result in any undue preference or undue discrimination. n7

n1 Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol [*FERC Statutes and Regulations, Regulations Preambles* 1982–1985 P30,665] (1985), *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 Statutes and Regulations* P30,761 (1987).n2 Section 7, 15 U.S.C. § 717f (1982).n3 Section 311, 15 U.S.C. § 3371 (1982).n4 18 C.F.R. Part 284 (1988).n5 The Commission recognizes that the caption to this order only includes proceedings that are pending before the ALJs and not proceedings that are pending before the Commission. The Commission intends to apply the principles set out here to cases pending before it on a case-by-case basis.n6 *Transcontinental Gas Pipe Line Corp. v. State Oil and Gas Board of Miss.*, 474 U.S. 409, 422 (1986).n7 *See, e.g., Order No. 497, Inquiry Into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines, FERC Statutes and Regulations* P30,820 (1988) for a discussion of the Commission's concern about possible abuses in the relationship between pipelines and their marketing affiliates.

[**3] To date, the Commission has permitted transportation rates to be used that were not in strict compliance with the requirements of Part 284. This has been allowed in order "to encourage pipelines to begin transporting under the new regulations and to gain some experience with the operation of the new regulatory scheme." n8 However, the Commission has now gained experience with the Part 284 ratemaking methodology and the "pipelines have had experience providing transportation under the Part 284 regulations." n9 Hence, pipelines must demonstrate, and the Commission will ensure, that pipeline "rates comply with the requirements of Section 284.7 of the regulations." n10 In addition, pipelines will "bear the [*62,052] burden of justifying any deviations from the requirements of the regulations." n11

n8 *El Paso Natural Gas Co.*, 46 FERC P61,079, at p. 61,349 (1989).n9 *Id.*n10 *Id. See also Northern Natural Gas Co.*, 45 FERC P61,097, at p. 61,318 (1988).n11 46 FERC P61,079, at p. 61,349.

This policy statement will deal with significant aspects of the rate design process and related matters. In particular, [**4] this policy statement will discuss seasonal rates, the division of fixed costs between the demand n12 and commodity n13 charges, capacity adjustments, discounted transportation, maximum interruptible rates, and rates for forward haul and backhaul transportation and exchange arrangements.

n12 The appropriate transportation rate term is reservation fee. However, demand will be used in this order to refer to both the sales and transportation charges for the right to capacity.n13 Commodity is a misnomer for a transportation rate because transportation is a usage service. Nonetheless, commodity will be used in this order to refer to both the sales and transportation charge for units purchased or shipped.

II. Rate Design Objectives1. *General Principles*The ratemaking process begins with the establishment of a cost of service or revenue requirement, continues through a series of steps by which the costs are assigned to various services and customer groups, and concludes with development of unit rates. n14 The establishment of a cost of service thus of necessity links rate design to costs. However, it has been recognized that the assignment of costs "is not a matter for [**5] the slide rule. . . . It has no claim to an exact science." n15 It "is not reducible to a simple mathematical exercise." n16 This means that cost assignment is more than a simple mechanical accounting procedure of cost causation. Rather, cost assignment is a means for accomplishing a complex of sometimes contradictory goals and for reconciling often conflicting interests in the process of assigning revenue responsibility among the pipeline's diverse services and customers. The Commission's task is to weigh all relevant considerations by "integrat[ing] cost factors with non-cost factors and policy considerations" to fashion rates for each customer which are within the zone of reasonableness. n17 Hence, the Commission is "not required to adopt any particular rate design." n18 It is the "total effect" of the rate design method which counts rather than the particular rate design method employed. n19 Thus, the Commission encourages the participants in these proceedings to develop different methods to achieve the rate objectives, set forth in the Commission's regulations and discussed below, that are tailored to the particular circumstances of a pipeline's system.

n14 The pipeline's cost of service or revenue requirement is assigned to its customers through the rate design process. The first step in the rate design process is to divide the cost of service among the pipeline's major operations or functions such as production, gathering, transmission and storage. This step is called cost functionalization. The next step is to categorize the pipeline's functionalized costs as either fixed or variable costs. The pipeline's costs are then classified (i.e., assigned) to the demand and commodity components of its rates. This step is traditionally called cost classification. Next, the classified costs are allocated between the pipeline's jurisdictional and nonjurisdictional services, and among its jurisdictional zones. This step is called cost allocation. Last, unit rates for each service are determined. This step is also known as rate design. *See Tennessee Gas Pipeline Co.*, 46 FERC P61,113, at p. 61,441 n.3 (1989).n15 *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581,589 (1945).n16 *Fuels Research Council, Inc. v. FPC*, 374 F.2d 842,846 (7th Cir. 1967).n17 *Northern Indiana Public Service Co.*

v. *FERC*, 782 F.2d 730, 742 (7th Cir. 1986), citing *FPC v. Conway Corp.*, 426 U.S. 271, 277-79 (1976).n18 *Id.* at 739.n19 *Fuels Research Council, Inc. v. FPC*, 374 F.2d 842, 850-51 (7th Cir. 1967), citing *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1942).

[**6] The Commission notes that to the extent a particular method is theoretically consistent with these objectives but leads to undesirable or inequitable results, pragmatic adjustments can and should be made. These concerns will be addressed in particular cases after designing rates in light of the other goals. Then, the Commission can make any necessary adjustments to mitigate harsh or undesirable results.² *Theory — Economic Efficiency* Section 284.7 of the Commission's regulations sets forth the Commission's objectives in designing transportation rates. Sections 284.7(c)(1) states that "[r]ates for service during peak periods should ration capacity." Section 284.7(c)(2) provides that "[r]ates for firm service during off-peak periods and for interruptible service during all periods should maximize throughput." As stated above, those objectives are of equal applicability to the transportation portion of bundled sales rates. The objectives provide guidance in the development of rates that promote economic efficiency; that is, the efficient functioning of natural gas markets. Transportation rates (and policies) which inhibit efficient operation of markets are themselves inefficient [**7] and cannot result in an equitable assignment of the pipeline's costs or revenue responsibility. The Commission is concerned with allocative and productive efficiency. Hence, economic efficiency [*62,053] is a necessary, but not necessarily the only objective which will enable the Commission to fashion just and reasonable, nondiscriminatory rates for all customers through the rate design process. Allocative efficiency simply means that those who value the product or service the most should be the ones to have it. Productive efficiency simply means that products and services should be provided at the least possible cost. A price or rate is inefficient if a different pricing scheme can be developed which would make all ratepayers and the company better off. n20 For example, discounting prices to or above marginal costs to attract business will benefit other customers by lowering their contribution to fixed costs. Hence, a scheme which inhibits discounting may be inefficient and inequitable. n21

n20 Put another way, an efficient pricing scheme is one where no one can be made better off without making someone else worse off.n21 See *Associated Gas Distributors v. FERC*, 824 F.2d 981, 1010-11 (D.C. Cir. 1987). ("[P]ipeline transportation service is marked by a degree of natural monopoly. . . In such an industry, 'value of service' ratemaking (*i.e.*, rates varying on the basis of differing demand characteristics) has an established place, though not an uncontested one. The equitable argument in favor of such differentials is that they may benefit captive customers by making a contribution to fixed costs that otherwise would not be made at all. (The efficiency argument is that such differentials will raise total volume closer to the level it would attain if all sales were priced at marginal cost.)" (Footnotes omitted)).

[**8] Section 284.7 of the Commission's regulations reflects the Commission's goals of allocative and productive efficiency in the fashioning of maximum rates by requiring that peak rates ration capacity and that rates maximize throughput during all periods. The Commission has recognized in section 284.7(d)(3)(i) that it will be necessary in certain instances to achieve those objectives by the use of seasonal rates for peak and off-peak periods. Moreover, the Commission has recognized in section 284.7(d)(5) that it may be necessary to selectively discount maximum rates to meet competition and attract or maintain business. n22 Rates designed to attain those objectives should result in an efficient allocation of capacity to those who value it and in productive efficiency by eliminating disincentives in the transportation of gas. n23

n22 18 C.F.R. § 284.7(d)(5). See *Associated Gas Distributors v. FERC*, 824 F.2d 981, 1010-1012 (D.C. Cir. 1987) ("For nearly 100 years, . . . the courts have interpreted the antidiscrimination provisions of the Interstate Commerce Act to allow the ICC to approve differentials justified exclusively by competition.") (at 1011).n23 The Commission recognizes that heretofore it has required allocation using the "first-come first-served" principle, with some possible reallocation where a new shipper is willing to pay a higher rate up to the maximum rate and the existing shipper is unwilling to match the higher rate. That principle has led to the current positions in the queues for firm and interruptible transportation services today on open access pipelines across the country under the first-come, first-served mechanism as currently implemented. A shift in emphasis now to mechanisms and rates which more directly allocate capacity to those who value it more highly may require a transition, as individual rate cases are considered; and the Commission encourages the parties to consider how best to accommodate such transitions, while avoiding any unnecessary complication of or disruption to transportation services provided across the country. The Commission also acknowledges that individual pipeline systems may have characteristics which justify various transitional mechanisms in any reorientation of capacity allocation methodologies.

[**9] In addition, a pipeline's sales and transportation services must be equivalent services in their treatment of the transportation of gas. Neither the transportation nor the sales service should provide a subsidy to the other service.

In short, there should be no cross-subsidization between transportation and sales services. As the Commission has stated: [I]n light of the goals of this rule, rates should be so designed that the transportation component will not differ whether the customer is purchasing sales or transportation service. n24

n24 Order No. 436, *supra* n. 1, at p. 31,535.

Of course, transportation and sales rates should recognize any differences in the quality of those services. For example, where firm sales customers have the benefit of all of a pipeline's production area facilities and firm transportation customers are limited in their access to receipt points to their aggregate mainline quantities, different maximum rate treatment would be justified. The absence for firm transportation customers of proportional access to production area facilities, flexible receipt points, and equal access to system storage facilities would justify a lower maximum rate [**10] than that embedded in the sales rate. Since rates should reflect the quality of the service, a lower quality service should have a lower rate. With this discussion in mind, the Commission turns to specifics of the rate design process on which it wants a record to be developed. III. The Issues The Commission observes that the issues to be discussed, such as the derivation of seasonal [*62,054] rates, demand charges, maximum interruptible rates, and discounted rates are interrelated because they encompass the division of costs (i.e., revenue responsibility) among various services and customers. The end result of the ratemaking process should as a whole promote the Commission's goals of, among other things, allocative and productive efficiency as discussed above. The ALJs and the participants must develop records which delve into and resolve the following issues consistent with the directions of this policy statement. In addition, the participants must establish records on, and the ALJs must consider and articulate the impacts (benefits and detriments) of, the various rate design proposals on the participants, on the various segments of the industry, and on classes of customers. The ALJs [**11] are also directed to explicitly articulate equitable factors considered in designing the rates, for example, whether rates design changes should be phased in. n25

n25 See p. 5 *supra* on pragmatic adjustments.

1. *Annual Versus Seasonal Rates* Section 284.7(d)(3) provides that rates "must reasonably reflect any material variation in the cost of providing service due to . . . [w]hether the service is provided during a peak or off-peak period." The Commission has referred to the cost of fuel used to run compressors as an example of a cost that might differ or vary between peak and off-peak periods. n26 However, section 284.7(d)(3) only requires that at a minimum such marginal costs as the cost of compressor fuel be considered. Other factors such as differing demands for service between peak and off-peak periods may be considered. Based on experience, the Commission is concerned that the derivation of demand and commodity rates without regard to seasonal variations in use of, or demands on, the pipeline does not properly ration peak capacity or lead to efficient use of the pipeline in periods of excess capacity.

n26 See, e.g., *Texas Eastern Transmission Corp.*, 37 FERC P61,260, at pp. 61,705-06 (1986).

[**12] Accordingly, evidence must be presented as to whether a pipeline has sufficiently differentiated patterns of usage to justify peak and off-peak demand or commodity rates or both to fulfill the goal of economic efficiency. n27 If seasonal rates are warranted, then costs incurred to perform peak season service (such as the cost of certain system storage facilities) should be assigned solely to that service and other costs assigned to the peak period based on demand factors. n28 That is, differences in the demand for service between periods should be recognized in rates to efficiently ration capacity. However, it should also be considered whether the costs associated with the peak service period are appropriately reflected in the demand charge but are merely billed throughout the year to reasonably soften the impact on consumers of otherwise high peak fuel bills. These rates are seasonal with only the payment schedule levelized. The payment schedule of rates should not affect how the rates are designed.

n27 It appears that many pipelines have a five-month winter peak from November 1 through March 31. The remaining seven months are off-peak. This may vary by company. n28 One approach would be to assign seasonal costs by seasonal load factors. Another might be to assign the cost of transmission facilities used to provide service above the annual load factor to the peak period. The remaining transmission costs could be divided evenly between the seasons. For example, if the peak period load factor is 90 percent, the annual load factor is 50 percent, and D-1 costs are \$100, then \$70 would be assigned to the peak period ($90\% - 50\% = 40\% \times \$100 = \$40 + 50\% \times \$60 (\$100 - \$40) = \$30$), and \$30 would be assigned to the off-peak period ($50\% \times \$60 (\$100 - \$40)$).

[**13] 2. *The Demand and Commodity Charges*. *General* The process of dividing (i.e., classifying) fixed transmission and storage costs between the demand and commodity components is closely related to the seasonal rate issue as both involve the assignment of costs for the purpose of peak pricing to achieve the Commission's goal of rationing peak capacity to those who value it the most. In addition, cost classification, by determining the level of costs in the commodity charge, is relevant to the Commission's goal of throughput maximization. At present, most pipelines' costs are classified under the

modified fixed variable method (MFV). The MFV method classifies all fixed production and gathering costs, all variable costs, and return on equity investment in transmission and storage facilities and related income taxes to the commodity component. The remaining fixed costs, including return of investment in transmission plant and storage facilities (i.e., depreciation expense), are classified to the demand component. n29 The MFV demand component currently consists of two demand charges. The first, or D-1 charge, reflects peak considerations. The second, or D-2 charge, reflects [**14] annual considerations. The costs classified to the demand component are [*62,055] assigned to the D-1 and D-2 charges on a 50-50 basis.

n29 Upstream pipeline charges are assigned to the downstream pipeline's demand and commodity components in the same manner as the charges are billed by the upstream pipeline to the downstream pipeline. This is the "as-billed" doctrine.

The Commission is concerned that MFV may be outdated in light of the significant changes in the nature of the gas pipeline industry since the adoption of Order No. 436 in 1985 and the further decontrol of gas under the NGPA. n30 In particular, the MFV division of costs between the demand and commodity components was designed to help pipelines in their role as a merchant. n31 But today most major interstate pipelines are functioning primarily as transporters. In addition, the D-2 charge was adopted in part to soften the impact on low load factor customers of the shift of fixed costs from the commodity charge to the demand charge. However, those very customers have objected to the D-2 charge on the ground that D-2 nominations will, in fact, shift costs to the low load factor customers. n32 Moreover, the transition period [**15] has been completed. n33 Hence a D-2 charge may no longer be warranted. n34

n30 MFV was first adopted in 1983 in *Natural Gas Pipeline Company of America*, 25 FERC P61,176 (1983), *order on reh'g*, 26 FERC P61,203 (1984), *aff'd in relevant part, Northern Indiana Public Service Co. v. FERC*, 782 F.2d 730 (7th Cir. 1986). n31 MFV changed the assignment of fixed costs to the commodity charge from either the *United* method's 75 percent or the *Seaboard* method's 50 percent. In almost all cases, this reduced the share of fixed costs in the commodity charge. n32 *E.g., Tennessee Gas Pipeline Co.*, 46 FERC P61,113, at pp. 61,445-46 (1989). n33 *Transcontinental Gas Pipe Line Corp.*, 46 FERC P61,364, at p. 62,139 (1989). n34 *See also Id.*

b. *The Central Question* The task is to determine the division of fixed costs between the peak related charge (D-1) and the charges associated with annual usage (the D-2 and commodity charges). The central question is whether the costs assigned to the D-1 charge are appropriate in amount [**16] to ration peak capacity to those who value it the most. n35 The answer may depend on whether there is a waiting list for firm capacity. Such a queue may indicate that the present D-1 (peak) charge is not rationing capacity. If capacity is consistently underbooked, it may be that the D-1 (peak) charge is excessive. In either event, the price is not appropriate because it produces an inefficient allocation of capacity on the pipeline. If the D-1 charge needs to be increased to properly reflect the demand for peak service, costs (i.e., revenue responsibility) could be shifted from the D-2 charge or, if necessary, from the commodity charge. As to the latter, examples are fixed storage costs n36 or some portion of return on equity. n37 In addition, as discussed above, the D-2 charge may no longer be warranted. In that case, any costs remaining therein after a shift of costs to the D-1 charge should be moved into the commodity charge. Moreover, the use of seasonal rates may also obviate the need for a D-2 charge. In addition, the issue of whether and how *undue* cost shifts should be mitigated in the *short run* (such as by a phasing in mechanism) should be considered. The [**17] aim is to soften the initial impact not to change an otherwise just and reasonable assignment of cost or revenue responsibility. The ALJs and the participants must develop records to resolve the issues discussed here.

n35 The Commission recognizes that customers on many pipelines do not have the opportunity to adjust their contract demand volumes, but that such adjustments may be necessary to efficiently ration capacity. *See infra* Capacity Adjustments. n36 The return and taxes on system storage investment are in the commodity charge at present and even though allocated by seasons, the storage may perform a peaking service and may belong wholly in the demand charge. n37 For example, the return on equity up to the T-bill rate and related taxes might be reassigned to the D-1 charge with the remainder of the return and associated taxes staying in the commodity charge.

3. *Capacity Adjustments* The use of peak and off-peak rates and a change in cost classification might result in a shifting of a substantial amount of costs to the charge for peak service. As stated above, the Commission's goal in any shifting of costs to peak service is to ration peak capacity by price [**18] to those who value it the most. Therefore, the participants to these proceedings must address and explore various ways to provide a contract demand adjustment option in tandem with increased charges for peak service due to the implementation of seasonal rates or classification changes to achieve the rationing capacity objective. For example, pipelines and their customers must pursue contract demand reductions in conjunction with peak rate increases. In addition, it might be appropriate for customers to have different daily contract

demand rights for peak and off-peak periods. Or, customers could be permitted the use of different daily contract demand rights on a monthly basis. n38

n38 See also *Transcontinental Gas Pipe Line Corp.*, 46 FERC P61,364, at p. 62,139 (1989).

Additionally, the pipelines should consider offering a short-term contract demand adjustment option to its firm sales and transportation [*62,056] customers. Firm sales and transportation customers could agree to release their capacity to the pipeline for a fixed term to enable the pipeline to resell the capacity as firm transportation under Part 284. For example, a firm customer might [**19] conclude that it wants to retain its contract demand but that at present it is not needed to serve customers in one season or for one or two years. The firm customer would inform the pipeline of this. The pipeline might have other customers or potential customers that want the assurance of firm transportation service for short terms as opposed to interruptible service. The pipeline would be obligated to offer the capacity for transportation under Part 284 of the Commission's regulations. It would have to sell the released capacity on a nondiscriminatory basis and not favor affiliates and would charge rates pursuant to sections 284.7 and 284.8. Under this kind of arrangement, the pipeline would share the proceeds with the firm customers releasing capacity. n39 The details of such capacity releasing, including the method of sharing proceeds and operational procedures, n40 would be determined in the individual proceedings. n41

n39 If proceeds are shared with the customer releasing capacity, costs need not be allocated to the transportation service that would be provided with the released capacity. n40 For example, the pipeline might establish a separate queue for this service with priority going to those in any current queue for firm service. n41 The capacity releasing described above differs from capacity brokering as described in the proposed capacity brokering rulemaking in Docket No. RM88-13-000 (Brokering of Interstate Natural Gas Pipeline Capacity, Proposed Regulations, *Statutes and Regulations* P32,460 (1988)) and the United experiment described in *United Gas Pipe Line Co.*, 46 FERC P61,060 (1989) in the following ways. The pipeline, not its customer, would be the only supplier of the service. The pipeline would be subject to the unlawful discrimination proscription of its open-access certificate for these transactions. Last, the pipeline would receive a fee as an incentive for the resale of its customer's firm capacity.

[**20] Nothing stated here should be viewed as preventing the participants from considering either capacity brokering n42 or capacity reassignment by firm shippers. n43 The Commission has given the pipelines and participants a wide range of options so that they can tailor their services to their particular needs.

n42 See citations in footnote 41. n43 See *Wyoming-California Pipeline Co.*, 45 FERC P61,234, at p. 61,678 (1988), *reh'g denied*, 46 FERC P61,310, at pp. 61,927-28 (1989).

4. *Discounting and Maximum Interruptible Rates.* Section 284.7(d) requires a pipeline to file maximum and minimum transportation rates for both firm and interruptible service and permits the pipeline to charge rates to customers within the maximum and minimum range. Under this section a pipeline is permitted to discount in order to maximize throughput and thereby benefit customers by spreading fixed cost recovery over more units of service. Section 284.7(c)(3) states the rate objective that "[t]he pipeline's revenue requirement allocated to firm and interruptible services should be attained by providing the projected [**21] units of service in peak and off-peak periods at the maximum rate for each service." n44

n44 A pipeline's projected units of service may only be changed by the pipeline in a section 4 rate filing. The projected units of service concept involves giving pipelines an incentive to maximize throughput. Selective discounting furthers similar objectives, by allowing pipelines to retain and attract business by meeting competition. Order No. 436, *supra* n. 1 at p. 31,546; Order No. 436-A [*FERC Statutes and Regulations, Regulations Preambles* 1982-1985] P30,675, at p.31,679 (1985).

Many have read this requirement to mean that a pipeline must assume in filing its next rate case that the volumes it has transported at discounted rates would still be transported if the maximum rate were charged. In light of the competitive market that has emerged in the gas industry, this assumption is not a realistic one. In other words, the problem with this objective is that if a pipeline must assume that previously discounted service will be priced at the maximum rate when it files a new rate case there may be a disincentive to pipelines discounting their services in the future to capture [**22] marginal firm and interruptible business. That would occur because the pipeline might not be able to recover its cost of service, if the maximum rates are based on throughput achieved by discounting. The court in *Associated Gas Distributors, v. FERC* described this situation and stated that there was no reason to suppose that the Commission intended for a pipeline to calculate prices assuming the carriage of discounted traffic at a fully allocated price. n45

n45 824 F.2d 981, 1012 (D.C. Cir. 1987).

The objective set forth in section 284.7(c)(3) was designed to prevent subsidization of the discounts by the pipelines'

nondiscounted rates. n46 That objective must be achieved in light of Order No. 436's goal of maximizing throughput. Therefore, the following discussion indicates ways to calculate a pipeline's rates after it has been discounting so as to achieve both objectives set out in the regulations.

n46 See Order No. 436, *supra* n. 1 at p. 31,545.

[*62,057] At the outset, however, the Commission reiterates that pipelines must give discounts on a non-discriminatory basis, and the Commission is concerned about selective discounts that have the [**23] potential for giving rise to undue discrimination, including discounts to affiliates. n47 The following discussion about how to design rates to avoid a disincentive to discounting transportation rates does not alter the standards that apply to the Commission's review of a pipeline's decision as to when and how to discount. That is, discounts must be given on a nondiscriminatory basis, and discounts to affiliates will be carefully scrutinized, n48 as will be the treatment of past discounts in projecting future units of service.

n47 See Order No. 497, note 7 *supra* at p. 31,135. n48 See Order No. 436, *supra* n. 1 at p. 31,546 and Order No. 436-A, *supra* n. 44 at p. 31,679 (1985).

One approach would be that maximum rates can be derived using separate estimates of units to be transported at the maximum rate and at discounted rates. Projected revenues from volumes at the maximum rate would be derived using only the units projected to be transported at the maximum rate. Revenues for service which can be retained or acquired at less than the maximum rate should be derived by a separate estimate of revenues assuming the lower rates. Another approach to avoid penalizing [**24] the pipeline for discounted service would adjust the volumes attributable to "undiscounted" throughput by adding to those volumes some portion of the volumes that were transported under discounted rates. For example, if a unit of service can only be sold at one third of the maximum rate, one third of a unit would be added to projected "undiscounted" throughput. The Commission also recognizes that in a rate case it may be difficult to forecast discounted units of service at particular prices. For example, discounts may depend on variables, such as the prices of alternative fuels. Accordingly, the ALJs and participants should consider methods which deal with the problem of the difficulty in forecasting revenues from discounting and which also do not discourage the pipeline from transacting such business. n49

n49 The Commission encourages the participants to develop approaches to this issue which are consistent with the overall objective of encouraging efficiency. The Commission is willing to consider, along with other proposals, the following two approaches in treating discounted transportation volumes. One possible approach would be a benefit sharing approach whereby at one extreme no volumes or revenues are allocated to discounted interruptible service. The pipeline would share revenues with firm customers which did not use their total firm service, thereby making interruptible service available. The amount and method of sharing could be determined in the individual proceedings. In return, the pipeline would share the benefits of such service rather than keep all revenues from the discounted service. The firm customers would pay a higher rate for their service but in return would have the possibility of more than offsetting their higher rates by sharing the benefits of the pipeline's discounted service. A less extreme approach could be to allocate costs or revenue responsibility to discounted service in the proceeding. If the pipeline's revenues above marginal costs are below the costs assigned to the service, the pipeline and firm customers not using their total firm capacity would share in the burden of the deficit. If the revenues above marginal cost are in excess of the assigned costs, the pipeline would share excess revenues with its firm customers which did not use their total firm capacity. The amounts and methods of sharing the losses and gains would be determined in the proceeding. There also could be agreed upon predetermined amounts for the pipeline to absorb as losses or keep as gains before sharing begins.

[**25] b. *Maximum Interruptible Rates* This section deals with the determination of maximum interruptible rates. Section 284.7(d)(4) requires that maximum interruptible rates be determined by the allocation of volumes and costs to interruptible service. In practice, this has been accomplished by the use of the 100 percent load factor rate method. n50 As the Commission has recently stated, it is time to re-examine the appropriateness of 100 percent load factor rates. n51 The Commission stated:

n50 In formula form, where D means demand and C means commodity, the 100 percent load factor rate is computed as follows: $D-1/365 \times 12 + D-2 + C$ rate per Mcf per day. n51 *Transcontinental Gas Pipe Line Corp.*, 46 FERC P61,364, at p. 62,143 (1989).

The Commission has hitherto found that rates derived on a 100 percent load factor basis are just and reasonable. The central rationale has been that such a rate does no more than require interruptible customers to pay a rate which includes all of the fixed costs of providing service. Moreover, the Commission has found that any difference in quality between

interruptible and firm service is recognized by the fact [**26] that interruptible customers bear none of the risk of unused capacity because they pay only for service used. The Commission believes that its and the industry's increased experience with interruptible service demonstrates that it is time to re-examine the Commission's policy concerning 100 percent load factor rates with respect to both the cost incurrence and quality [*62,058] of service rationales and other factors, such as the customers' competitive posture *vis a vis* alternative fuels and the possible need for seasonally differentiated rates. Accordingly, the Commission will permit the parties in this proceeding as well as other proceedings where interruptible rates are at issue to explore the issue of whether lower rates than those derived on a 100 percent load factor basis are appropriate. n52

n52 *Id.* (Footnote omitted.)

The issue is whether the 100 percent load factor rate yields a maximum interruptible rate which is too high to efficiently maximize throughput and is therefore an inefficient allocation of costs or revenue responsibility to interruptible service. The answer depends on an analysis of the pipeline's package of rates and services and not merely on an examination [**27] of the 100 percent load factor method by itself. For example, the 100 percent load factor method may be an appropriate way to set a maximum rate which acts as a cap on a pipeline's market power where it is efficiently discounting to maximize throughput or where the pipeline is using peak and off-peak rates. Demand rates can also be viewed as both a charge for the right or option to use capacity and as a charge to cover the costs associated with the use of the capacity. If the demand rate is in part a charge for a right to capacity, some portion of the demand charge is not related to costs incurred in providing service. That is, a part of the demand charge will be associated solely with the value of the right to demand service. This approach may warrant excluding costs assigned to the demand charge in whole or in part when deriving maximum interruptible rates on an annual basis. Again, the use of peak and off-peak rates also may warrant the use of peak and off-peak maximum interruptible rates derived under the 100 percent load factor method. Last, the Commission repeats that a rate for service should reflect the quality of the service as compared to other services. n53 For example, [**28] capacity releasing, capacity brokering, and capacity assignment would create new classes of firm service. In addition, the ability to release, assign, or broker a service adds value to the service itself. The participants should address how these new services affect the quality of other services. The pipelines and participants can also consider different services which vary in quality from the traditional firm and interruptible services. The rates for both new and old services should reflect the different quality of the services.

n53 *See supra* p.8.

5. *Transportation Rates* The transportation of natural gas entails the movement of the gas from a point of entry into the pipeline to a point of delivery from the system. However, this is often accomplished by a process of displacement in which gas is delivered into the system and received from the system by adjusting pressure. At times, a shipper's gas will not make a continuous forward or direct haul. Section 284.7(d)(3) recognizes that there are different patterns of transportation in the pipeline industry by not mandating mileage-based rates. Section 284.7(d)(3) requires only that rates "reasonably reflect any [**29] material variation in the cost of providing service due to . . . [t]he distance over which the transportation is provided." Order No. 436 discussed this as follows: [For example], on most pipeline systems the costs of providing service are materially affected by the distance the gas is transported. The rates for such a pipeline should reflect these differences. But on other pipelines or for particular types of services distance may not materially affect the cost of providing service. In these situations the rates need not be based on mileage or zones. In short, all that is required is what is required of all rates: that they reflect the cost of providing the service. Again, the rate standards imposed by the rule will be applied in individual fact-specific cases. n54

n54 Order No. 436, *supra* n.1, at p. 31,538.

Where gas is moved in a forward haul an Mcf-mile rate may be appropriate, however, Section 284.1 defines transportation to include an "exchange, backhaul, displacement or other methods of transportation." Those forms of transportation consist of a wide variety of factual scenarios which make it difficult to formulate one policy to encompass all situations. The [**30] following discussion deals with forms of transportation which do not use capacity in a forward haul and therefore may create additional capacity. For example, backhaul transportation occurs when a shipper delivers gas to a pipeline downstream of the point where the shipper receives gas from the pipeline. Of course, there is no actual physical backhaul or reversal of flow. The transaction is effectively an exchange where the pipeline delivers either its own gas or another shipper's gas to the backhaul shipper in exchange for the latter's gas. n55 The backhaul or exchange may create additional capacity on the pipeline between the exchange (receipt and delivery) points and results in cost savings through the pipeline's avoidance of marginal [*62,059] costs. Hence, the pipeline's backhaul and exchange services are efficient. The question is how to price those services. The ALJs and the participants must develop records with respect to the

appropriate maximum rate a pipeline should charge for backhauls and exchanges. n56 In addition, backhaul and exchange rates are within the pipeline's selective discounting authority. While section 284.7(d)(4) requires that a minimum rate "be based on the [**31] average variable costs which are properly allocated to the service to which the rate applies," a no fee minimum rate may be warranted to permit pipelines and shippers to agree that no fee should be charged when an arrangement is mutually beneficial and produces substantially equal benefits. Last, backhauls and exchanges must be performed on a non-discriminatory basis. n57 In that regard, the Commission is concerned that pipelines generally might not offer no-fee or minimum-fee transactions to shippers other than other pipelines and pipeline affiliated shippers. The Commission intends that any pipeline offering such transactions to other pipelines and/or pipeline affiliated shippers must also extend the same opportunity to all other shippers under terms and conditions whereby all similarly situated shippers, regardless of pipeline or affiliate status, must have an equal opportunity to utilize such transactions. The Commission also notes that any such transactions between a particular pipeline and its affiliate would be subject to Order No. 497.

n55 In a more typical "exchange" arrangement, two or more parties would be delivering gas and two or more parties would be receiving gas. Quite often, the parties involved in such exchanges are interstate pipelines. n56 Cases where the Commission permitted pipelines to use their direct haul rates no longer embody Commission policy. *E.g., Texas Eastern Transmission Corp.*, 37 FERC P61,260, at p. 61,708 (1986); *Northern Natural Gas Co.*, 37 FERC P61,272, at p. 61,815 (1986). n57 *See Northern Natural Gas Co.*, 37 FERC P61,272, at p. 61,815 (1986).

[**32] IV. Separating Services Section 284.7(d) requires that a "rate . . . separately identify cost components attributable to transportation, storage, and gathering costs." However, section 284(d)(4)(i) also requires that rates "recover . . . solely those costs which are properly allocated to the service to which the rate applies." Hence, a pipeline should only charge for gathering and storage services actually performed for a customer. The ALJs and the participants are directed to fashion records to determine whether the pipeline's storage functions and gathering and other production area services, such as processing and production area transportation, should be offered as separate services with separately charged rates and, if so, what would be the appropriate rates. This does not mean that a bundled rate is inappropriate. The Commission, however, prefers fully unbundled services. In addition, the pipelines and the participants should explore, in addition to traditional service, the pipeline separately selling gas (the commodity) without the transportation service, with the customer using its right to capacity to move the gas. V. Conclusion The ALJs and the participants (including [**33] the Commission staff) should develop records consistent with the content of this policy statement. The ALJs are directed to reopen the records, if necessary, to develop the records on the issues discussed above. The participants must establish records on, and the ALJs must consider and articulate the impacts (benefits and detriments) of, the various rate design proposals on the participants, on the various segments of the industry, and on classes of customers. The ALJs are also directed to explicitly articulate equitable factors considered in designing the rates. n58 However, the participants are not limited to the methodologies and issues discussed above. The Commission will consider other methods that will achieve the goals of rationing peak capacity and maximizing throughput. The Commission emphasizes that it is not mandating a particular end result. As stated earlier, the end result is to be tailored to the particular circumstances of a pipeline system. To the extent a pipeline has several rate cases pending, the ALJs and the participants should decide in which proceeding it would be appropriate to develop records on the issues discussed above.

n58 *See p. 5, supra* on pragmatic adjustments.

[**34] In these proceedings the ALJs should not grant requests for late intervention by persons who seek to intervene to participate in the additional record development required by this order unless such late intervenors have a direct stake in the outcome of the proceeding and their interest would not be adequately represented by existing parties. The Commission intends that the ALJs exercise their discretion to grant late intervention in these cases very sparingly. The Commission does not intend to transform any of these proceedings into generic industry-wide forums for policy development. Any persons that are not currently parties to the rate cases listed in the caption to this order and any party in one of those rate cases that wants to seek rehearing of the general policy statements in this order should file in Docket No. PL89-2-000. [*62,060] Commissioner Stalon *concurred* with a statement to be issued later. Commissioner Trabandt *concurred* with a separate statement attached.

CONCURBY: TRABANDT

CONCUR:

Charles A. TRABANDT, Commissioner, concurring:1. *General* I concur generally with this rate design policy statement, even though I would have preferred strongly to adopt a stronger and more [**35] precise policy statement. I

also have very strong reservations about the discounting feature of the policy statement. While there have been several modifications to the draft discussed at the May 17, 1989, Commission meeting, I still have serious procedural and substantive concerns that have not been addressed. I discuss the following comments, recommendations, and revised text in an effort to sharpen the focus on those issues. I look forward to reviewing these matters further on rehearing. Hopefully, the Commission can resolve as many of these issues as possible in the final policy statement on rehearing.

2. Major Interstate Pipelines Not Included in the Policy StatementA. CommentThis issue was discussed at the May 17 meeting, but remains unresolved. I am still concerned that our failure to address rate design issues on these pipelines is a large gap in the interstate system by any measure. That failure also could extend a competitive advantage to these pipelines over competing pipelines directly subject to this policy statement. It also virtually precludes any hope of near-term uniformity and consistency in general rate design. Additionally, the Policy Statement [**36] largely reiterates rate design principles first enunciated in Order No. 436 in October 1985, after a Notice of Inquiry and a Notice of Proposed Rulemaking, so there has been more than abundant time over the past three and a half years to make adjustments to conform. The OPPR memo of May 19, 1989, indicates that nine pipelines are not included in this policy statement. They fall into five distinct categories described below. The dates in parentheses for each pipeline indicate when the pipeline would be obligated by current regulations (which could change as a function of other policy initiatives) to file a new rate case where the rate design issues could be addressed. I would note that most are at least a year away and some are late 1992. The categories and included pipelines are as follows:(1) Settlement just approved: Southern (10/89)(2) Initial Decision Pending: CIG (7/90)(3) Settlement certified and pending: Arkla (6/91), Natural (1/92), Texas Gas (11/92), Questar (11/91)(4) Settlement approved, but rehearing still pending: Algonquin (5/90), United (11/91)(5) New rate case filed, suspension order pending on May 31 Agenda: ANRFootnote 5 on page 2 of the slip op. [**37] acknowledges the fact that the caption does not include proceedings pending before the Commission, while stating an intent to apply the principles in the policy statement to those cases on a "case-by-case basis." Apparently, that case-by-case basis would involve a balancing of the degree of conformity with these rate design principles, the procedural status of the case, support or opposition and the overall acceptability of the rate proposal.I do not support a case-by-case approach to this requirement, because there are always cogent arguments for approving a settlement once it gets to the Commission. As noted above, there has been abundant time to implement most of these principles first enunciated in Order No. 436. In that regard, I would not be surprised if the Natural settlement scheduled for the May 31, 1989 Commission Meeting is largely approved, even though it deviates materially from the thrust of this policy statement on certain key features. That could likely be the pattern for the other eight pipelines as well.

B. RecommendationModify the order to state that, consistent with the Commission's intention that the identified rate design principles be addressed [**38] on an industry-wide basis and also to avoid any competitive advantage to a non-included pipeline, the Commission states its intent to require that parties in categories (2), (3), (4), and (5) above and Southern when it files the rate case to be effective 10/89 will be required to address the matters set forth in the policy statement. To that end, the Commission will issue supplemental orders in the respective dockets establishing expedited procedures to satisfy that requirement. The Commission notes that its failure to impose such a requirement would mean that those pipelines would not be required effectively to address these rate design issues for periods of from one to three and a half years, which would otherwise be unacceptable, and that those pipelines could obtain an important competitive advantage over the pipelines listed in the dockets in this order. (A compromise might be that the docket for any pipeline [*62,061] not required to file a new rate case within 6 months or 1 year would be subject to this requirement).

3. General Issue of Policy Direction or GuidanceA. CommentWhile I appreciate that there apparently is some disagreement about mandating specific rate design [**39] results, I believe the current draft is still too weak under any circumstances as a general matter (with the exception of discounting, discussed below, on which I disagree with the mandated result). Legally, under *Pacific Gas and Electric Co. v. FPC*, 506 F.2d 33 (D.C. Cir. 1974), we could go much farther if we chose to do so, either generally or on any specific issues. The court there sustained a strong FPC policy statement on curtailment priorities as that issue became manifest in a series of cases. The FPC had stated its intention to follow a particular end-use priority schedule, unless a particular company demonstrated that a different curtailment plan was more in the public interest or where extraordinary circumstances would preclude strict adherence to the curtailment policy in the policy statement. While opportunity would be afforded interested parties in specific cases to challenge or support the new policy through factual or legal presentations, the FPC concluded that, based on its review of the records of various proceedings and its general knowledge of the industry, the curtailment schedules should be applied to all jurisdictional pipelines, [**40] unless extraordinary circumstances could be established.Given our express acknowledgment that we have permitted rates that were not completely consistent with the objectives and requirements of Order No. 436 and our general experience otherwise, I believe, as a matter of policy, we should at least consider a stronger position in the order, (1) on a generic basis, and (2) with some or all of the individual rate design features. We would be on firm legal ground and we have full justification under the express requirements and

preamble discussion in Order No. 436. In the alternative, if we adopt the more "wishy-washy" approach in the current order for the Order No. 436 items, it can only signal that we continue to lack the requisite commitment or resolve to force these rate design features as a general matter consistent with the clear intent of Order No. 436. I would prefer strongly not to support that result. The following recommendation addresses the generic approach in the current draft.

B. RecommendationThe discussion in the first paragraph on page 3 is a positive assertion of our current intent to enforce the requirements of section 284.7 and require pipelines to bear [**41] the burden of justifying any deviation. Subsequent discussion of specific issues and the conclusion on page 20, however, can, and probably will, be read as a far lesser requirement that the parties in each case only really are required to address these issues, but not satisfy the objectives and specific requirements of Order No. 436 and section 284.7, among others. To preemptively negate that general impression, add the following statement before the last paragraph on page 21."Finally, the Commission reiterates its commitment that the rates on any jurisdictional pipeline subject to Order No. 436 must comply with the requirements of Order No. 436 generally and specifically with the requirements of Section 284.7 of the regulations, unless the pipeline persuasively establishes that a particular deviation is justified on that system. In that regard, based on our review of various Order No. 436 proceedings and our general knowledge of the industry in today's market situation, we have concluded generally that, barring extraordinary circumstances justifying such a deviation, the rate design features set forth in Order No. 436 must now be implemented on all subject pipelines. While [**42] opportunity will be afforded to interested parties in specific cases as set forth above, we have resolved to be guided generally in our review of the cases by that conclusion."

4. Annual Versus Seasonal Rates**A. Comment**Section 284.7 clearly establishes the requirement for much more than lip service to this rate design feature. The NGSa petition (Appendix A, page 2) indicates that the following major pipelines did not then have seasonal rates: ANR, Columbia, Columbia Gulf, Consolidated, El Paso, Natural, Northern, Northwest, Panhandle, Southern (filed, but rejected), Tennessee, Texas Eastern, Transco, Transwestern, Trunkline, and United. Today, most, if not all, of those pipelines still do not have seasonal rates in place, although there has been some increased interest by some pipelines in various statements or filings. On balance, it is still clear that pipelines are still objecting to this aspect of 284.7. [**62,062]

B. RecommendationModify the order to make clear that there is at least a presumption in support of seasonally differentiated rates. On page 9, add the following sentence at the end of the first paragraph under "1. Annual Versus Seasonal Rates." "The [**43] Commission, therefore, concludes that seasonally differentiated rates generally should be adopted, unless the pipeline can demonstrate that exceptional circumstances exist which justify some deviation from fully seasonally differentiated rates. Where such deviation can be justified on an individual pipeline basis, the pipeline nevertheless would be expected to satisfy the stated objectives of section 284.7 in the context of the deviation." Also, modify the second sentence of the next paragraph to remove the apparent ambiguity or "wishy-washiness," as follows: Instead of "If seasonal rates are warranted . . .," modify to read, "For seasonal rates required unless there is a justified deviation, cost incurred . . ."

5. Demand and Commodity Charges**A. Comment**As discussed at the May 17 meeting, I remain concerned that, while we have questioned whether the Modified Fixed Variable Method (MFV) may be outdated, we have not been specific enough as to our general direction to provide any meaningful guidance to the parties. Although we honestly may not have a specific result in mind, we should do more than just raise the question alone as the issue in the cases. It is not [**44] enough to say (1) that most pipelines today are transporters (since only 10% of CD has been converted to F.T. and the vast bulk of transportation is I.T.) or (2) that the intended beneficiaries, the low load factor customers, have objected in some cases to the application of MFV. I recommend we stake out at least an opening position for purposes of an analytical point of departure in the industry-wide reconsideration of MFV.

B. RecommendationOn page 11, before subparagraph "b. *The Central Question*," insert the following additional discussion: "In particular, the Commission is concerned that in today's natural gas market the MFV two-part demand charge has the effect of shifting costs of pipeline capacity to off-peak usage with rates for firm capacity largely unrelated to the value and true cost of the rendered service. The result can effectively insulate the firm customer from the true fixed costs of the firm service, such that the rates may provide an incentive for the uneconomic retention or "hoarding" of firm capacity rights leading to a major impediment to the availability of firm, rather than interruptible, service. A shift away from the MFV two-part demand charge, [**45] with a more reasonable balance in the assignment of fixed costs, could provide a greater incentive for customers to reserve only capacity rights actually needed. Such a shift also could prevent situations where firm customers are able to understate D-2 volumes and maintain a firm claim on pipeline capacity by paying relatively modest demand charges, by comparison to the real value of the firm service. (Cite to the *Tennessee et al.* line of cases on D-2 nominations). One possible approach to respond to these concerns would be a return to the straight, as opposed to modified, fixed-variable allocation and rate design methodology. Other methodologies might conceivably address these concerns. However specifically resolved and addressed, the Commission intends that future demand and commodity charge allocation methodology should affirmatively remove any incentive for the uneconomic "hoarding" of firm capacity rights and otherwise ensure that demand costs are fairly allocated to customers on the basis

of their respective contract demand."6. *Capacity Adjustments*A. *Comment*The concept of CD reduction has been added to the order on page 12, but only in a fleeting way. [**46] Some embellishment should be added to ensure that there is no ambiguity about the message.B. *Recommendation*Insert the following after the new sentence (first full one) on page 12:"The Commission believes that the use of contract demand conversion without contract demand reduction would not support any significant shifting of costs to peak service, because the firm customer would not have a reasonable opportunity to adjust the total firm requirements to reflect current needs and reallocated costs. Additionally, in light of the Commission's intention to remove any identified incentive for firm capacity hoarding and any disincentive to a more economically rational contract [*62,063] demand requirement, contract demand reduction probably is a necessary feature of an adjustment mechanism to provide firm customers with the capability to develop a reasonable firm and interruptible service portfolio as necessary to meet current and projected requirements over time."7. *Discounting*A. *Comment*The order addresses the issue of discounting in a manner that appears to be clearly "results oriented," to the effect that there can be "no disincentive" to pipelines providing transportation [**47] rate discounts. I discussed the issue at the May 17 meeting and continue to believe that the order goes too far. The order effectively gives the pipelines a blank check in its current form, even though the clear intent of Order No. 436 was directly contrary to that result. Ironically, I would guess that at least 50% or more of the current transportation volumes on most pipelines (which nationwide approximate 75% of total throughput) are with discounted rates, because of competition in the marketplace. That's one part of Order No. 436 which has worked reasonably well and it is absurd in the extreme to conclude that current rate treatment is such a disincentive that pipelines must have a blank check, lest they discontinue discounting. Discounting will only be limited or ceased when, and only to the extent that, a pipeline has a competitively advantageous position to allow it to maintain maximum throughput levels at incrementally higher or maximum rates. The Commission must not open the door to understated volumes and, as a result, higher unit rates on such a flimsy analytical and evidentiary basis. To date, in fact, we have had only two related cases on this issue. Discounting [**48] is going to continue as a matter of competitive necessity, if not survival, in today's natural gas market. But, that is not a reason to invite the misallocation of costs that inevitably would result from this proposal. We already are confronted with the reality that selective discounting probably provides one of the greatest opportunities for affiliate preferences, which we must address in Order No. 497-A. I see no reason to further compound the discounting problem with potential cross-subsidies and needlessly higher transportation rates for nonaffiliated shippers.As noted, this issue has recurred directly in two specific cases worth some attention. In *CNG Transmission Corporation*, 44 FERC P61,203 (1988), The pipeline included as a credit to its cost of service \$9 million in revenues related to transportation services of 35.5 million Dt. The rate proposed to be charged for the transactions was significantly below CNG's proposed generally applicable transportation rate. The Commission rejected CNG's proposal stating that the pipeline "was shifting the cost burden of its transportation discounts from the company to other transportation customers," [**49] "regulations promulgated under Order No. 436 were designed to prevent such cross-subsidization," and "CNG would have a competitive advantage over pipelines that are bearing (such cost burden) responsibility." The Commission took the same position in *Questar Pipeline Company*, 43 FERC P61,127 (1988), but subsequently in its Order Granting In Part Appeal of Staff Action of February 1, 1989, with regard to the compliance filing in the same docket (46 FERC P61,115 (1989)) decided not to summarily reject a revision of the throughput projection, but rather made reasonableness of the projection an issue in the pending hearing. At the same time, the Commission reiterated the general view that led to the original rejection, and distinguished the revised throughput projection in the compliance filing on the narrow basis that it was arguably consistent with the Commission's prior order, even though it may later prove to be inaccurate or otherwise produce unlawful rates. It is unambiguously clear, therefore, that the Commission's interpretation of Order No. 436 and its consistent practice until today is directly contrary to the plain [**50] meaning and obvious result of this section of the policy statement.While there may be a legitimate question of how to properly allocate historical, discounted volumes in calculating new transportation rates, several key principles of Order No. 436 remain relevant and applicable. First, the pipeline must remain at risk without question for the revenue results of discounting under any given rate structure, including any underrecovery. Second, there cannot be any cross-subsidy of the discounts by rates for other services. The current draft clearly "finesses," if not practically repeals, Section 284.7(c)(3), and those key principles of Order No. 436 in the discussion, particularly paragraphs 2 and 3 on page 15 of the slip opinion. Also, although the text makes specific reference to Order No. 497, the strong impression of the discussion is that there should be no *regulatory* (rate or otherwise) disincentive or impediment to otherwise unconstrained pipeline flexibility to engage in selective discounting for affiliated and non-affiliated shippers. Additionally, all calculations using past discounted volumes [*62,064] must take into account and properly balance/reflect the extent to which [**51] such volumes were discounted for affiliated shippers. I also am quite concerned that this feature of the policy statement is intended to lay the ratemaking foundation for the Incentive Rate of Return initiative and also the so-called "productivity gain" concept. For all these reasons, I would modify it.B. *Recommendation*Modify the discussion to "neutralize" the statement of the

problem *and* the Commission's response to make clear that the principles of Order No. 436 (as well as Order No. 497) will continue to apply, even where there may be a demonstrated need for some flexibility on throughput calculation and the effect of discounted volumes. Remove the "results oriented" discussion and examples memorializing support for cross-subsidies and reduced/eliminated pipeline risk of underrecovery due to discounting, such as under the benefit sharing approach. Require that all calculations of past discounted volumes take into account and properly reflect/balance the extent to which such volumes were discounted for affiliated shippers. (See Appendix for a proposed modified discussion). What evidence (*e.g.*, *CNG*, *Questar*, the 1988 INGAA report, etc.) exists to support the [**52] conclusion that this may be a real world problem which, in fact, requires some generic policy response from the Commission? The current discussion provides no evidentiary or experiential antecedent to the extensive discussion. In effect, what is the need for any attention to discounting in this policy statement in the first place?8. *Maximum Interruptible Rates*A. *Comment*The discussion of the 100% load factor method in the order appears to be a retreat from the Commission's most recent pronouncements. The better result would be to establish the general presumption that, all other things being equal, the Commission believes that the current usage of 100% load factor probably is inconsistent today with the reasonable and fair allocation of costs to shippers.B. *Recommendation*On page 17, insert a new sentence after the first sentence of text, as follows:"Based on its review to date, the Commission believes that generally the 100% load factor in current practice probably does not result in a reasonable and fair allocation of costs to shippers, in the absence of other compensating and offsetting adjustments, and today is not consistent with the stated rate objectives [**53] of Order No. 436."9. *Mileage-based Rates*A. *Comment*The order again appears to retreat from the clear intent of Order No. 436 that rates be mileage based, unless there is an adequate justification for the departure. The NGSA petition, Appendix A, page 7, indicates that 10 major pipelines have implemented large zones approximating postage stamp rates (ANR, Columbia Gulf, El Paso, Natural, Northern, Panhandle, Southern, Transwestern, Trunkline, and United), three others have postage stamp rates (Columbia, Consolidated, and Northwest), and three others have four or more zones (Tennessee, Texas Eastern, Transco). For example, the issue will recur again in cases on the next agenda, with results that are inconsistent with Order No. 436. The point is that the Commission's failure to expressly support this requirement of Section 284.7 is tantamount to acquiescence in its continued avoidance by pipelines in cases and settlements.B. *Recommendation*Insert a new paragraph after the text ending with footnote 55 on page 19."The Commission emphasizes that Order No. 436 intends that rates be reflective of the distance gas is transported. Thus, pipelines generally should [**54] implement rates which do not constitute "postage stamp" rates where shippers pay the same charge whether the gas travels one mile or a hundred miles or more. That form of rate discourages alternative and more economically efficient transportation and market approaches, whereas rates based on mileage or small zones will foster competition and encourage the use of the most economically efficient alternative path to market. Thus, a pipeline is required to justify any deviation from rates which directly reflect differences in the distance of the transportation service."10. *Separating Services*A. *Comment*The new section on page 20 is an improvement over the original draft, which was virtually silent on unbundling. The discussion, [**62,065] however, is too understated in its current form and, thereby, suggests that the Commission is not totally committed to pursuing the unbundling objective clearly established in Order No. 436. The NGSA petition documents the fact that a significant number of pipelines have not unbundled storage costs, gathering and third party transportation costs (Account No. 858). The issue also comes up repeatedly in pending cases and this would be a timely [**55] opportunity to express the Commission's view in support of further unbundling. Also, we should make clear the importance of (1) FT equivalency and (2) the less restricted availability of storage, as we did in the recent *Transco* and *Tennessee* GIC "paper hearing" orders.B. *Recommendation*In the new paragraph on page 20, modify the sentence beginning, "This does not mean . . ." to read as follows:"This does not mean in every case that a bundled rate is necessarily inappropriate. However, the Commission reiterates here the clear objective of Order No. 436 that rates be unbundled for separate services, and costs be allocated fairly to those services. That general result will better ensure that there will be a more efficient use of the pipeline's facilities, that competition of a gas to gas nature will be on a more equal basis, and that the allocation of costs will reflect better the economic value of the services. For example, as a general matter, unbundled rates for gathering, treating, processing, storage, and transmission services will best reflect costs associated with each service and the value of the service to customers. Also, transportation rates generally [**56] should not include Account No. 858 costs related to transportation of system supply gas on upstream third party pipelines, since those costs are related solely to the sales service and are incurred only when the pipeline purchases gas for its sales to customers. Similarly, the Commission, as a general matter, has concluded that the transmission element of (1) a pipeline's sales service and (2) its firm transportation service should be functionally equivalent with comparable rate (cite to *Transco/Tennessee*). And, the pipeline should not unjustifiably restrict access to separate storage services provided with appropriately unbundled rates. Thus, the Commission has concluded generally that, unless otherwise justified in a particular rate case applicable to an individual pipeline, Order No. 436 requires pipelines to proceed now to develop rates which reflect this concept of

unbundling."11. *Theory—Economic Efficiency*A. *Comment*My view on the over-emphasis on economic efficiency in the earlier draft was discussed at the May 17, 1989 Commission Meeting. Suffice it to say that I remain very concerned that there is an over-emphasis on the theory and the so-called "Commission [**57] goal" of allocating capacity (and by inference, other services) to those who value it the highest. That leads potentially to such ill-starred and analytically deceased initiatives as "auctioning" all transmission capacity, for which we have two consultant reports serving as an academic obituary, and the capacity brokering NOPR, where the staff technical conference proved that we could not, as a threshold matter, define the "right" to be brokered in the first instance, thus constituting a *de facto* funeral for the generic initiative. I would not want this "economic efficiency theory" discussion to serve as the Phoenix resurrecting those largely decomposed concepts from the well-deserved ranks of the analytical dead.B. *Recommendation*Interested parties should consider carefully the potential negative implications of this primacy of economic efficiency approach, in terms of today's transportation activities and considerations of equity, fairness and non-discrimination.12. *Order No. 497-AA*s the preceding discussion makes abundantly clear, this Policy Statement would increase materially the concerns associated with undue discrimination against non-affiliates and preference [**58] for affiliates. The remedy for that increased concern lies in immediate and acceptable action on the rehearing of Order No. 497 including, but certainly not limited to, an extension of the reporting requirement for several years beyond December 31, 1989. We, therefore, should adopt the Policy Statement only if final and favorable action on Order No. 497-A is scheduled promptly.13. *Conclusion*These comments and recommendations are intended to facilitate with specific proposals the improvement of the overall posture of this Policy Statement, in terms of the degree of guidance provided to the parties in these cases and the industry at large. This policy statement provides us with a timely and [*62,066] effective opportunity to redirect pipeline rate design in a much more market-oriented and competitive direction this year. I look forward to reviewing these recommendations further on rehearing. In the end, I hope we can reach agreement to strengthen the guidance along these lines.For these reasons, I concur.