though the asset will physically provide benefits for longer than the initial contract term and to other customers.

This policy gives prospective shippers an opportunity to influence a significant part of their rates (*i.e.*, the depreciation component) by their choice of contract length. Continuation of this policy, or a broader application of it, could also help resolve the ''need'' issue discussed below by encouraging a greater shipper commitment before capacity is built. The Commission could both encourage longer term contracting for new capacity and shelter existing ratepayers from capacity turnback by declaring that new pipeline costs are fully recoverable over the contract term that supports its construction. However, on the other hand, such a policy could make the rates too high to make the project economically viable, and also results in a situation where later ratepayers would not pay any depreciation component for use of the facilities.

The Commission seeks comments on what criteria it should use to determine a depreciation period and rate for ratemaking purposes. Parties may address some or all of the following questions.

Given that the industry will stay in a partially cost-based rate regulated environment (*i.e.*, for determining recourse rates), on what criteria should the Commission base a depreciation rate? Would customers be willing to sign up for life-of-the-facilities contracts, thus promoting long-term service? Is it fair to require initial customers who sign up for less than the life-of-the-facilities contracts to pay for all costs of the asset over that shorter term since future customers may use and benefit from the facilities? If the initial customers are unwilling to pay the full costs, should the pipeline be built?

If use of the economic life is more suitable to foster fairness between new and existing customers, how should the economic life or benefit period be determined? Should the economic life be viewed as the expected period of time customers will use the asset or should it be viewed as the known period of time that customers contracted for using the asset? What amount of depreciation, if any, should be allocated to short-term services? What criteria should be used to make this determination? Will the criteria be sufficiently objective to avoid claims of cross-subsidization? How should depreciation be treated when some of the rates are market-based? To what extent does depreciation flexibility aid pipelines having cost recovery problems? Lastly, how should capacity be priced after it has been fully depreciated by its first generation of customers?

For cost-of-service purposes, these questions are not easily answered. For general purpose financial accounting and reporting, the Commission has required pipelines to depreciate facilities over their economic useful life and record regulatory assets and liabilities for the differences between ratemaking depreciation and accounting depreciation.[31] What are the implications of different depreciation rates for cost-of-service rate purposes versus accounting purposes if some portion of pipeline rates is not based on traditional cost-of-service ratemaking? Will pipelines be able to continue to record the difference as a regulatory asset or liability? What about income tax related issues?

V. Comment Procedures

The Commission invites interested persons to submit written comments on the matters and issues discussed in this notice of inquiry, and any related matters or alternatives that commenters may wish to discuss. An original and 14 copies of comments must be filed with the Commission no later than November 9, 1998. Comments should be submitted to the Office of the Secretary, Federal Energy Regulatory Commission, 888 First Street, NE, Washington, DC 20426, and should refer to Docket No. RM98–12–000. All written comments will be placed in the Commission's public files and will be available for inspection in the Commission's Public Reference Room at 888 First Street, NE, Washington, DC 20426, during regular business hours.

Additionally, comments should be submitted electronically. Commenters are encouraged to file comments using Internet E-Mail. Comments should be submitted through the Internet by E-Mail to comment.rm@ferc.fed.us in the following format: on the subject line, specify Docket No. RM98–12–000; in the body of the E-Mail message, specify the name of the filing entity and the name, telephone number and E-Mail address of a contact person; and attach the comment in WordPerfect® 6.1 or lower format or in ASCII format as an attachment to the E-Mail message. The Commission will send a reply to the E-Mail to acknowledge receipt. Questions or comments on electronic filing using Internet E-Mail should be directed to Marvin Rosenberg at 202–208–1283, E-Mail address marvin.rosenberg@ferc.fed.us.

Commenters also can submit comments on computer diskette in WordPerfect® 6.1 or lower format or in ASCII format, with the name of the filer and Docket No. RM98–10–000 on the outside of the diskette.

By direction of the Commission.

David P. Boergers,

Acting Secretary.

[FR Doc. 98–20996 Filed 8–10–98; 8:45 am]

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[31] See Kern River Gas Transmission Company, 58 FERC 61,073; Mojave Pipeline Company, 58 FERC 61,074 (1992); Florida Gas Transmission Company, 62 FERC 61,024 (1993), Order Granting and Denying Rehearing and Granting Clarification FERC 61,093 (1993); TransColorado Gas Transmission Company, 67 FERC 61,301 (1994), Order Granting in Part and Denying in Part Rehearing and Granting Clarification, 69 FERC 61,066 (1994); Sunshine Interstate Transmission Company, 67 FERC 61,229 (1994); and Mojave Pipeline Company, 69 FERC 61,244 (1994), Order Granting Rehearing in Part, Denying Rehearing in Part and Modifying Prior Order, 70 FERC 61,296 (1995).

DEPARTMENT OF ENERGY

Federal Energy Regulatory Commission

18 CFR Parts 161, 250, and 284

[Docket No. RM98–10–000]

Regulation of Short-Term Natural Gas Transportation Services

July 29, 1998.

AGENCY: Federal Energy Regulatory Commission.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Federal Energy Regulatory Commission (Commission) is proposing an integrated package of revisions to its regulations governing interstate natural gas pipelines to reflect the changes in the market for short-term transportation services on pipelines. Under the proposed approach, cost-based regulation would be eliminated for short-term transportation and replaced by regulatory policies intended to maximize competition in the short-term transportation market, mitigate the ability of firms to exercise residual monopoly power, and provide opportunities for greater flexibility in the provision of pipeline services. The proposed changes include initiatives to revise pipeline scheduling procedures, receipt and delivery point policies, and penalty policies, to require pipelines to auction short-term capacity, to improve the Commission's reporting requirements, to permit pipelines to negotiate rates and terms of services, and to revise certain rate and certificate policies that affect competition.

DATES: Comments are due November 9, 1998.

ADDRESSES: Federal Energy Regulatory Commission, 888 First Street, NE, Washington DC, 20426.

FOR FURTHER INFORMATION CONTACT:

Michael Goldenberg, Office of the General Counsel, Federal Energy Regulatory Commission, 888 First Street, NE, Washington, DC 20426. (202) 208–2294

Erica Yanoff, Office of the General Counsel, Federal Energy Regulatory Commission, 888 First Street, NE, Washington, DC 20426. (202) 208–0708

Ingrid Olson, Office of the General Counsel, Federal Energy Regulatory Commission, 888 First Street, NE, Washington, DC 20426. (202) 208–2015.

SUPPLEMENTARY INFORMATION: In addition to publishing the full text of this document in the **Federal Register**, the Commission also provides all interested persons an opportunity to inspect or copy the contents of this document during normal business hours in the Public Reference Room at 888 First Street, NE, Room 2A, Washington, DC 20426.

The Commission Issuance Posting System (CIPS) provides access to the texts of formal documents issued by the Commission. CIPS can be accessed via Internet through FERC's Homepage (http://www.ferc.fed.us) using the CIPS Link or the Energy Information Online icon. The full text of this document will be available on CIPS in ASCII and WordPerfect 6.1 format. CIPS is also available through the Commission's electronic bulletin board service at no charge to the user and may be accessed using a personal computer with a modem by dialing 202–208–1397, if dialing locally, or 1–800–856–3920, if dialing long distance. To access CIPS, set your communications software to 19200, 14400, 12000, 9600, 7200, 4800, 2400, or 1200 bps, full duplex, no parity, 8 data bits and 1 stop bit. User assistance is available at 202–208–2474 or by E-mail to CipsMaster@FERC.fed.us.

This document is also available through the Commission's Records and Information Management System (RIMS), an electronic storage and retrieval system of documents submitted to and issued by the Commission after November 16, 1981. Documents from November 1995 to the present can be viewed and printed. RIMS is available in the Public Reference Room or remotely via Internet through FERC's Homepage using the RIMS link or the Energy Information Online icon. User assistance is available at 202-208–2222, or by E-mail to RimsMaster@FERC.fed.us.

Finally, the complete text on diskette in WordPerfect format may be purchased from the Commission's copy contractor, La Dorn System Corporation. La Dorn Systems Corporation is located in the Public Reference Room at 888 First Street, NE, Washington, DC, 20426.

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Notice of Proposed Rulemaking

Five years have passed since Congress, in the Wellhead Decontrol Act, completed the decontrol of natural gas prices. Six years ago the Commission, in Order No. 636, unbundled the purchase of gas from the purchase of gas transportation. Since then, the natural gas market has changed from a largely regulated market to one increasingly driven by market forces. In order to continue to fulfill its statutory duties to ensure just and reasonable rates in the rapidly evolving gas market of today, the Commission has engaged in a comprehensive, critical examination of the regulatory assumptions and procedures that it has been using to determine whether other regulatory approaches would better fit the needs of this changing marketplace.

Since Order No. 636, the natural gas marketplace has fundamentally changed. Active short-term markets have begun to develop. Shippers are trading gas at market centers on a daily or sometimes an intra-day basis with prices varying from day-to-day. Prior to Order No. 636, the majority of contracts were long-term with less price volatility. As local distribution companies (LDCs) unbundle the gas commodity from transportation, new players, such as electric cogenerators, industrial end-users, and small businesses (such as restaurants) are entering the gas marketplace with gas and transportation needs different from those of the LDCs that previously transported and sold the majority of gas. Increasingly, LDC unbundling is even bringing homeowners into the gas marketplace. These new entrants often use marketers or other facilitators to arrange for their gas supplies on a delivered basis.

The use of transportation capacity also has changed. Before Order No. 636, shippers could acquire transportation only from the pipeline. They could buy gas from the pipeline at the city-gate either on a short-term or long-term basis, acquire long-term firm capacity from the pipelines, often with 20-year contracts, or purchase short-term interruptible capacity. In today's market, shippers have additional options. They can acquire capacity from other firm capacity holders through the capacity release market. They also can obtain capacity indirectly by purchasing gas bundled with transportation from producers, marketers, or aggregators for one delivered price (often called a gray market sale).

The changes in the short-term market have caused the Commission to closely examine its regulatory structure to see whether it provides a good fit with the developing short-term market. The Commission has received comments on the impact of these changes through a number of proceedings, among them a prior Notice of Proposed Rulemaking (NOPR) on the secondary market,[1] a request for comments on whether pipelines should be permitted to

[1] Secondary Market Transactions on Interstate Natural Gas Pipelines, Notice of Proposed Rulemaking, 61 FR 41046 (Aug. 7, 1996), IV FERC Stats. & Regs. Proposed Regulations ¶ 32,520 (Jul. 31, 1996).

negotiate terms of service,[2] and an industry conference on issues and priorities in the gas industry.[3]

Upon review of the changes in the market and the comments it has received, the Commission is concerned that its current regulatory approach, which relies on a constant maximum rate in the short-term market, may not be the best approach in light of the variability in pricing in the short-term market. Due to the variability in transportation value, the current approach may not provide the best protection against the exercise of market power during peak and off-peak periods. Or, the protection it does provide may come at the expense of a more efficient capacity market during peak periods, when shippers are most in need of a market that works efficiently.

The Commission recognizes that despite all the competitive improvements in the short-term market, the short-term market still may not be fully competitive. Thus, the Commission must continue to have a regulatory presence in the short-term market to protect against the exercise of market power and undue discrimination.

The Commission is, therefore, proposing in this NOPR a different approach for regulating the short-term transportation market which is designed to permit the market to function efficiently while continuing to protect shippers against the exercise of market power. This approach has a number of objectives. It is designed to improve competition in short-term markets by facilitating the trading of capacity, so that shippers will have a larger number of capacity alternatives from which to choose. By expanding options, it seeks to help reduce the number of captive customers. Additionally, it seeks to provide the opportunity for greater flexibility in pipeline contracting practices so that pipelines can design services that better meet the needs of existing and new players in the gas marketplace.

The proposal uses different regulatory structures for short-term and long-term markets. Long-term transportation prices (i.e., transportation of one-year or longer) would continue to be regulated under a cost-based regulatory regime to protect against the exercise of pipeline monopoly power. For short-term transportation services, however, cost-based regulation would be eliminated. In its place, the Commission proposes to regulate the short-term market through regulatory policies that are intended to maximize competition in the short-term transportation market, to mitigate the ability of firms to exercise residual monopoly power, and to improve the ability of market participants and the Commission to monitor the market for exercises of monopoly power or undue discrimination. The goal of this approach to the short-term market is to ensure that the Commission's regulatory policy does not inhibit competitive market forces from creating efficient capacity markets, while still providing captive customers and others with protection against the exercise of market power in the transportation market.

Specifically, to maximize competition (which is the best protection against the exercise of market power) the Commission is proposing in this NOPR to revise pipeline nomination and scheduling procedures, and flexible receipt and delivery point policies so that capacity release can compete on a more equal footing with pipeline capacity. To further mitigate the exercise of market power and the potential for undue discrimination, the Commission is proposing to require that all short-term capacity be sold through capacity auctions. To improve shippers' and the Commission's ability to monitor the marketplace the Commission is proposing changes to its reporting requirements. To improve competition across the pipeline grid, the Commission is making proposals to change pipeline penalty procedures so that penalties, although necessary to deter conduct inimical to system operations, do not unnecessarily limit shippers' competitive alternatives.

At the same time, the Commission recognizes that changes in the short-term market also influence shippers' decisions in the long-term market. For example, the value of long-term capacity lies in the guarantee of capacity at a relatively stable price as compared with buying capacity at the more volatile short-term price. Long-term contracts, therefore, are a means by which shippers and pipelines can manage the risks inherent in the short-term market.

To foster greater innovation in pipeline services and to permit pipelines and shippers to better allocate the risks of long-term contracts, the Commission is proposing to allow pipelines' greater flexibility in negotiating contracts with individual shippers, subject to criteria that will protect captive customers against the risk of undue discrimination. Further, to create a more efficient marketplace, regulatory policies should not affect the allocation of risk between acquiring short-term or long-term capacity. As part of this integrated package, therefore, the Commission is proposing changes to some of its policies governing long-term contracts to ensure that these policies do not unfairly bias shippers' contracting decisions. The Commission also is considering whether changes to its policies regarding authorization for new construction are needed so that these policies do not unnecessarily limit competition.

The Commission recognizes that the impact on the long-term market of the changes in the short-term market go beyond the proposals outlined above. Therefore, in a Notice of Inquiry (NOI) issued contemporaneously with this NOPR, the Commission asks for additional comment on the future direction of its policies for pricing of long-term capacity.

I. Reexamination of the Transportation Market

A. The Developing Short-term Market

Natural gas markets have developed rapidly since wellhead price deregulation and unbundling of pipeline merchant and transportation services. In many ways, the gas market performs very well, without the loss of reliability that many feared when Order No. 636 was being contemplated.[4]

Gas commodity markets have arisen, along with market mechanisms to enable consumers to manage price risk for the gas.[5] There are monthly and growing daily spot markets for gas supplies which enable shippers not only to buy their own gas supplies at the wellhead, but to trade gas among themselves on a daily or even more frequent basis. Many of these spot markets are organized around market centers that facilitate trading of gas across pipelines as well as providing a variety of new services, such as storage, wheeling, parking, lending, electronic gas trading, and tracking of gas title

[2] Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, and Regulation of Negotiated Transportation Services of Natural Gas Pipelines, 61 FR 4633 (Feb. 7, 1996), 74 FERC ¶ 61,076, at 61,242 (1996).

[3] Issues and Priorities for the Natural Gas Industry, PL97–1–000 (conference held May 29–30, 1997).

[4] *See* Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 636, 57 FR 13267, FERC Stats. & Regs. Regulations Preambles [Jan. 1991–June 1996] ¶ 30,939, at 30,408 (Apr. 8, 1992), Order No. 636–A, 57 FR 36128 (Aug. 12, 1992), FERC Stats. & Regs. Regulations Preambles [Jan. 1991–June 1996] ¶ 30,950, at 30,570 (Aug. 3, 1992) (concerns about providing transportation service equal in reliability to bundled sales service).

[5] *See* S. Walsh, A Hot (and Cold) New Investment Opportunity, Washington Post, July 4, 1998, C12 (Business) (discussing development of new weather derivative to enable companies to hedge against abnormal weather patterns).

transfers.[6] Active forward markets also have developed to enable gas consumers to hedge against price risk. The New York Mercantile Exchange (NYMEX) launched its natural gas futures contract in 1992, and it is very heavily traded.

Along with the development of a more liquid commodity market, shippers' transportation options have expanded. In the past, shippers could purchase capacity only from the pipeline and had, for the most part, only two transportation choices: long-term firm capacity or interruptible service. Pipeline offerings have expanded as well, with pipelines offering short-term firm transportation service, pooling,[7] hub services,[8] parking and loan services,[9] and both short-term and long-term storage services.[10]

Non-traditional players also have entered the capacity market, so that today firm shippers holding pipeline capacity include electric utilities (21% of total pipeline firm capacity), industrial end-users (5%), marketers (17%), pipelines (7%), and others, including producers (6%) in addition to the traditional LDCs (44%). While many of these shippers still hold pipeline contracts longer than a year, short-term firm contracts are rising in significance. Among the shipper groups, marketers are the largest users of short-term capacity, with over three-quarters of the total.[11]

In today's market, shippers also have the added option of buying firm capacity released by other shippers in a variety of ways (such as on a fixed, or volumetric basis, or with other release conditions, including provisions for handling capacity recalls). Since its inception in 1992, capacity release transactions have been growing dramatically.[12] For instance, the amount of capacity held by replacement shippers for the 12 month period ending March 1997, totaled 7.4 quadrillion Btu, a 22% percent increase over the previous 12 month period and almost double the level for the 12 months ending March 1995.[13] While the amount of capacity held by replacement shippers declined during the heating season, EIA reports it still represents a sizable amount.[14] Despite the growing use of released capacity, interruptible pipeline service also continues to be a viable service option, maintaining a relatively constant share of throughput.[15] As in the case of released capacity, EIA reports that interruptible service is available during the heating season.[16]

In addition to acquiring capacity from pipelines and releasing shippers, purchasers in the short-term market have other capacity options. Implicit in the Commission's decision to unbundle the gas commodity from transportation was a recognition that the market would develop so that customers who did not want to assume the responsibility of purchasing or transporting their own gas could purchase delivered gas from marketers or third parties with the marketer providing all or a portion of the needed transportation, for example to a nearby market center.[17] Capacity rights holders can now sell gas as a commodity in downstream markets at market-based prices.

Further, as a result of Commission initiatives, the gas industry, through the Gas Industry Standards Board (GISB), has developed standards that make it easier to move and trade gas on individual pipeline systems and across pipeline systems.[18] These standards establish a daily, along with an intra-day, nomination schedule which permit shippers to adjust their nominations to conform to changes in weather and other circumstances. The Commission recently adopted GISB standards providing for three intra-day nomination opportunities.[19] These standards also significantly enhance shipper flexibility, for example, by giving shippers the ability to aggregate gas supplies from numerous sources in a pipeline pool for nomination purposes and by allowing shippers to assign priority rankings to gas packages.

These changes, operating together, have changed the character of short-term markets. Five years ago, most gas was purchased during bid week under monthly contracts and transportation was arranged at the same time on a monthly basis. Transactions occurring outside of bid week were unusual and were referred to as the aftermarket. Today, daily markets for gas and capacity are developing rapidly. Shippers now trade gas on a daily or even an intra-day basis at various market centers and pipeline interconnect points or at pipeline pooling points. For example, at pipeline interconnect points or at pools, there may be repeated sales of the same gas between producers and marketers before the gas is scheduled for transportation. As described in a recent proceeding, shippers can use pooling to effectuate gas exchanges (pool to pool transfers) as a means of enhancing supply and pricing options and of market hedging.[20] For example, a shipper may buy gas from a pool as insurance against a change in its system requirements and then sell that gas to another pool if the load does not develop in its market.

Shippers also can take advantage of trading opportunities by making daily or intra-day changes to their gas nominations to react quickly to changing weather, changing prices or supply sources, or other circumstances. For instance, a shipper that loses a supply source can submit an intra-day nomination to change its receipt point for gas so that it can purchase gas from an alternate supply source. The reports in trade publications of daily gas prices at delivered markets are further evidence of the increasing scope of the developing short-term market.[21]

The developing gas market, however, is in some respects still in its infancy and there are still impediments, both regulatory and non-regulatory, to the

[6] Department of Energy/Energy Information Administration, Pub. No. DOE/EIA–0560(96), Natural Gas 1996 Issues and Trends, Chapter, The Emergence of Natural Gas Market Centers (1996).

[7] *See* Standards For Business Practices Of Interstate Natural Gas Pipelines, Order No. 587, 61 FR 39053 (Jul. 26, 1996), III FERC Stats. & Regs. Regulations Preambles ¶ 31,038 (Jul. 17, 1996) (requiring pipelines to provide pooling services).

[8] *See* Moss Bluff Hub Partners, 80 FERC ¶ 61,181 (1997) (firm storage and interruptible hub services); Egan Hub Partners, L.P., 77 FERC ¶ 61,016 (1996) firm storage and interruptible hub services).

[9] *See* Mojave Pipeline Company, 79 FERC ¶ 61,347 (1997); Colorado Interstate Gas Company, 83 FERC ¶ 61,273 (1998).

[10] *See* Koch Gateway Pipeline Company, 66 FERC ¶ 61,385 (1994) (firm and interruptible storage); New York State Electric Gas Corporation, 81 FERC ¶ 61,020 (1997) (issuing certificate).

[11] Department of Energy/Energy Information Administration, Pub. No. DOE/EIA–0618(98), Deliverability on the Interstate Natural Gas Pipeline System 88–89 (1998).

[12] *Id.* at 82 (representing about 16% of the gas delivered for market).

[13] *Id.* at 83.

[14] *Id.* at 85–86 (2,960 trillion Btu from November to March 1996–97).

[15] *Id.* at 85 (about 16% of total throughput for the 12 months ending March 31, 1997).

[16] *Id.* at 87 (2,000 TBtu moved during heating season).

[17] *See* Order No. 636, FERC Stats. & Regs. Regulations Preambles [Jan. 1991–June 1996] ¶ 30,939, at 30,410.

[18] Standards For Business Practices Of Interstate Natural Gas Pipelines, Order No. 587, 61 FR 39053 (Jul. 26, 1996), III FERC Stats. & Regs. Regulations Preambles ¶ 31,038 (Jul. 17, 1996), Order No. 587–B, 62 FR 5521 (Feb. 6, 1997), III FERC Stats. & Regs. Regulations Preambles ¶ 31,046 (Jan. 30, 1997), Order No. 587–C, 62 FR 10684 (Mar. 10, 1997), III FERC Stats. & Regs. Regulations Preambles ¶ 31,050 (Mar. 4, 1997), Order No. 587–G, 63 FR 20072 (Apr. 23, 1998), III FERC Stats. & Regs. Regulations Preambles ¶ 31,062 (Apr. 16, 1998).

[19] Standards For Business Practices Of Interstate Natural Gas Pipelines, Order No. 587–H, 63 FR 39509 (Jul. 23, 1998), 84 FERC ¶ 61,031 (July 15, 1998).

[20] El Paso Natural Gas Company, 81 FERC ¶ 61,174, at 61,760 (1997) (approving a limit on pool to pool transfers because pipeline could not handle the volume of transactions under new scheduling timeline).

[21] *See, e.g.*, Gas Daily, March 2, 1998, at 1–2; Natural Gas Intelligence, Jan. 5, 1998, at 4; Natural Gas Week, Jan. 12, 1998, at 12, 17, 20–21.

development of a well-functioning market. Price information, which is crucial to a well-developed market, could be improved. While the Commission requires the posting of information on capacity release transactions, posting of pipeline discount transactions occurs well after-the-fact and cannot be used by shippers to make daily market decisions. Moreover, it is difficult for shippers to obtain accurate information about delivered gas transactions or the value of transportation inherent in such transactions. Shippers are left to personal communication or trade publications to determine prices at receipt and delivery points. Acquiring market information through personal communication is time consuming and expensive, particularly for small customers who would have difficulty canvassing a large enough number of sources to obtain sufficient market information. Each trade publication uses different reporting methods. Some mix long and short-term transactions and some report price ranges while others report averages, and most do not report quantities traded.

Also, capacity markets are fragmented. Different regulatory rules apply to pipeline sales of interruptible and firm capacity, capacity obtained through release transactions, and capacity used as part of delivered gas transactions. For example, the nomination and scheduling procedures and rate regulation differ among pipeline capacity, released capacity, and delivered gas transactions. In addition, different rights may apply depending on the type of capacity a shipper tries to acquire. Shippers purchasing released capacity from certain firm shippers may have to rely on alternate receipt or delivery points, and the use of such points are sometimes restricted by pipelines' tariffs.

All of these factors increase the shippers' transaction costs by increasing the difficulty and risk of doing business in the short-term market. Absent good price and capacity information, shippers cannot easily compare capacity alternatives or obtain full, comparable information about the alternatives available at any time. This inhibits their ability to make informed decisions about acquiring gas and capacity and prevents them from finding the best gas and capacity deals available. These costs may be particularly meaningful for small customers, who do not have the time and resources to unearth, through personal contacts, the information they need to make informed choices.

In the developing short-term market, market forces impact regulated services. The growing emphasis on daily transactions means that customers are more concerned with the daily price of transportation capacity. For example, many short-term decisions are based on the delivered price for gas (including transportation) on a daily basis. Often narrow differences in delivered prices may affect shippers' decisions.

The existence of a market price for gas at all points along the pipeline grid has created a market-driven value for transportation between receipt and delivery points. In effect, the implicit value of transportation between two such points is the spot price of gas at the delivery point minus the spot price of gas at the receipt point.

This market driven value can fluctuate widely on a daily basis. As shown in the following example, many such valuations remain near zero for long periods of time, only to rise during periods of peak demand. On this illustration, the market-driven value of transportation represents the difference between the spot price for gas at the upstream hub in Louisiana and the delivered price for gas in the New York downstream market. In other words, the price for delivered gas in the downstream New York market reflects the spot price for gas at the upstream hub plus the value of the transportation needed to deliver the gas to the downstream market. The market value of transportation can then be compared with the cost-based, regulated maximum interruptible rates for the three pipelines transporting from Louisiana to New York (represented by the dotted lines).[22]

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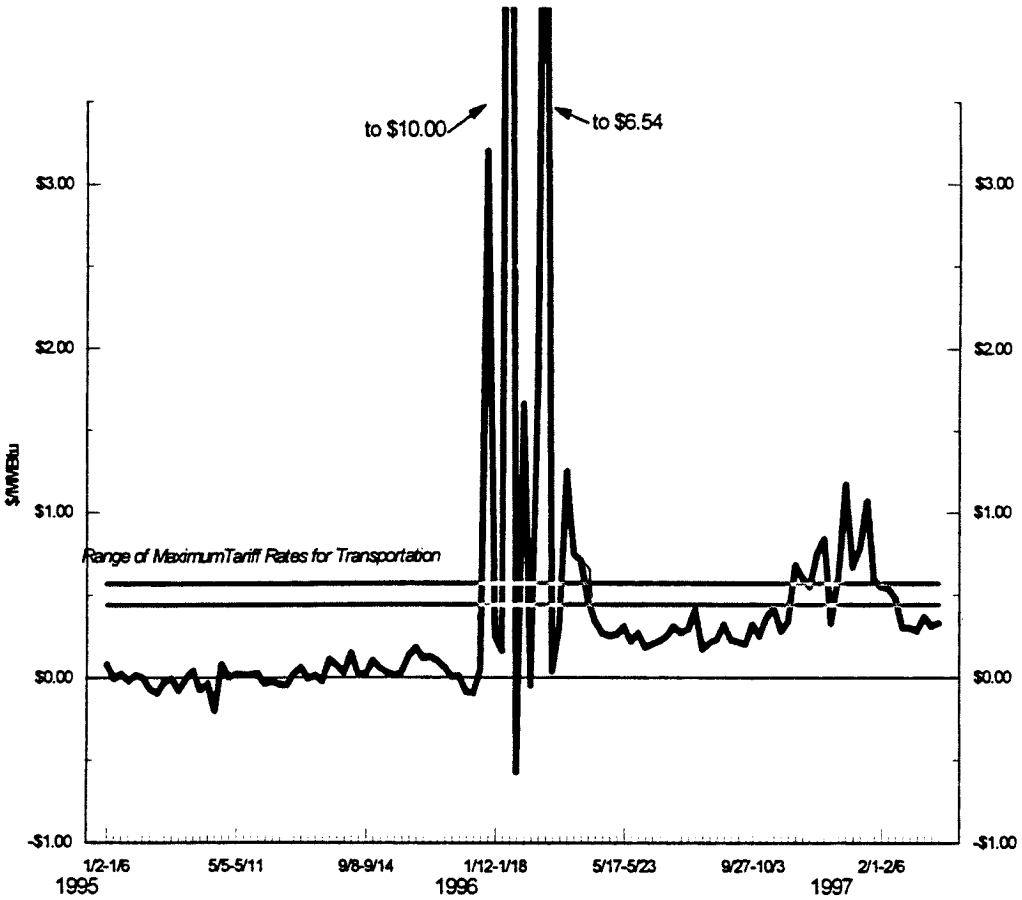
[22] The source for the spot price data is the Gas Daily Weekly Weighted Average Prices ($/MMBtu). The source for the maximum interruptible tariff rate is from PIPELINE Grid published by the Petroleum Information Corporation Logistics Solution. The range of tariff rates includes the interruptible rates from Columbia Gas Transmission Corporation ($.45/MMBtu), Tennessee Gas Pipeline Company ($.57/MMBtu), and Transcontinental Gas Pipe Line Corporation ($.44/MMBtu).

Implicit Price of Transportation
South Louisiana to New York

(Average Weekly New York Spot Price minus
Average Weekly South Louisiana Spot Price)

January 1995 to March 1997
($/MMBtu)



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This illustrates that the value of transportation during the peak winter period of 1995–1996 rose to $10/MMBtu (20 times the maximum daily tariff rates of between $.44 and $.57/MMBtu) and during the 1996–1997 winter to over $1/MMBtu (2 times the maximum tariff rate). During non-peak periods, the value of transportation was uniformly below the maximum daily tariff rate. While the illustration may not portray precise transportation values,[23] it nonetheless does provide a picture of the fluctuation in transportation values over time.

The fluctuation of transportation values raises questions about whether the Commission's current rate policies are attuned to the realities of the developing short-term market. The Commission currently establishes a daily maximum rate for pipeline services and capacity release by taking the pipelines' annual rate and converting it to a daily rate (by dividing the yearly rate by 365). But this single rate does not reflect the variability of daily pricing in the short-term market. While the $10 value during the 1995–1996 may not be repeated, transportation values during the next winter were double the maximum rate.

These data on delivered prices, and derived transportation values, do not establish either the presence or absence of market power. Delivered markets for gas can, and probably do, coexist with the continued exercise of market power over transportation. Pricing by a pipeline with market power would exhibit the same pricing variability as shown in the illustration, with higher prices during periods when demand is greatest. Also, even though prices during off-peak periods are below the maximum rate, that does not guarantee that market power cannot be exercised.

The existence of a delivered market does not, in and of itself, establish that the market is operating efficiently. Regulatory impediments, such as poorly designed penalty structures or the maximum rate cap, may create transaction costs, reducing market efficiency and raising prices. The price

[23] For instance, gas from markets other than Louisiana may have affected delivered prices in New York, and the data contain unexplained anomalies, such as transportation values of less than 0, indicating that the price of gas was lower in New York than at the receipt point in Louisiana. During that time, either no gas moved from Louisiana to New York or, if gas did move, the markets were not clearing properly or the price data were not accurate.

cap, for instance, can create a disincentive for firm capacity holders to make capacity available for release during peak periods, because the capacity holder is unable to realize the market value for its capacity. This can create a less efficient market by depriving other shippers of the ability to obtain capacity when they place a greater value on the capacity than the shipper holding it.[24] The buyer's alternative is to try and purchase delivered gas. But the market for delivered gas may not be as efficient as giving the buyer the added option of purchasing transportation capacity in an open and transparent market in which the buyer can decide for itself whether it obtains greater value by purchasing delivered gas or using its own gas contracts and obtaining transportation separately.

In sum, the short-term market is changing, with greater emphasis on daily transactions and daily prices for the gas commodity both at origin and delivered markets which vary with demand. The constant maximum rate approach to regulation does not appear to fit well in this new fast-paced market and may result in a less efficient market, with increased transaction costs. Yet, market power over transportation continues to exist and must be addressed.

B. Implications for Commission Regulatory Policies of the Changing Nature of Short-term Markets

The development of active commodity markets at both ends of the pipeline poses a significant challenge to the Commission's traditional method of rate regulation. The current maximum rate provides some regulatory protection for shippers during peak periods, because it prevents pipelines from exercising monopoly power at least to the extent that shippers cannot be charged prices above the maximum rate. Even during off-peak periods, the maximum rate provides some protection because it protects some shippers against discriminatory prices that might otherwise exceed the cap. During off-peak periods, some shippers still place a high value on moving gas, and the price cap limits the price such shippers can be forced to pay. Moreover, the Commission permits pipelines to price discriminate (at prices below the maximum rate) during off-peak periods to provide benefits to captive customers who hold long-term firm contracts. The added revenue the pipeline generates by selectively discounting helps to reduce the reservation charges owed by the captive firm shippers.[25]

As the short-term market continues to grow, maximum rate regulation in the short-term market may become an increasingly more ineffective method of regulating the short-term market. Maximum rate regulation may not provide shippers with the most effective protection against the exercise of market power. Moreover, the protection it does provide may come at too great a cost in efficiency.

The rate cap may, for instance, result in misallocation of capacity where those shippers placing the greatest value on the capacity are unable to obtain it. During peak periods, pipelines can only sell capacity which is not under contract or used by those shippers holding firm capacity. Thus, a pipeline may have little capacity to sell on a peak day. Even if the pipeline did have capacity to sell, a particular shipper placing the highest value on the capacity may be unable to obtain that capacity. Under current Commission rules, when demand for capacity exceeds the supply available, and all shippers bid the maximum rate, the pipeline awards its capacity using a queue based on contract execution date or on a *pro rata* basis. In either case, the shipper placing the greatest value on the capacity may not obtain capacity or not obtain as much capacity as it needs and for which it is willing to pay.

The shipper's other alternative is to try to obtain capacity from firm capacity holders, but in this market the price cap may not provide much protection to the purchasing shipper. The price cap applies to released capacity. But, the price cap has little effect on delivered gas transactions, in which the transportation value may exceed the maximum rate.

There is little hard empiric evidence on how extensive the delivered market is, but the existence of delivered gas transactions during peak periods suggests that, due to the price cap, capacity holders with available capacity will choose to use that capacity to make delivered transactions, where the profit opportunity is greater, rather than releasing the capacity, where the price is capped. In addition, a pending proceeding raises the question whether shippers have developed other methods for avoiding the maximum rate that are difficult to detect and prevent on a systematic basis.[26]

Attempting to regulate the transportation component of delivered gas transactions would be difficult. But even if this market could be effectively regulated, it is not clear that such regulation would be beneficial. If capacity transactions could not occur above the price cap, then, as described above, capacity would not be allocated efficiently; those customers most needing gas during peak periods would be unable to obtain the gas they need and the market would not clear efficiently.

In addition, as described earlier, the price cap may reduce the efficiency of the delivered gas market itself by raising transaction costs, thus resulting in higher delivered prices. Because unbundled sales of capacity by releasing shippers cannot be made above the maximum rate, the market may not operate in as open, transparent, or efficient a manner as is possible. Information for delivered gas is not publicly posted and shippers relying on word of mouth may not be able to easily locate all available sources of transportation. The difficulty of locating potential sellers and obtaining accurate price information may lead some customers to pay higher than necessary prices.[27] For instance, during the winter of 1996 when gas prices rose dramatically, while the market worked well to prevent shortages and ensure that customers received gas, it could have worked more efficiently. According to the trade press, the delivered prices for gas in Chicago on the same day ranged from $20.50 to $46.00 per MMBtu.[28] In an efficient market, one would not expect such a wide differential in prices, but would expect transactions in the same market to clear at roughly similar prices. The Commission seeks input from the industry on whether the price cap creates transaction costs and prevents

[24] *See* Mary L. Barcella, How Commodity Markets Drive Gas Pipeline Values, Public Utilities Fortnightly, Feb. 1, 1998, 24, 25 (price cap limits shippers' incentive to release capacity and can result in shutting out other shippers needing capacity).

[25] During off-peak periods, the pipeline can price discriminate by offering discounts to some customers that are greater than those offered to other customers. This practice brings in more revenue than the pipeline would earn if it could only charge the same price to all customers. The additional revenue benefits the firm capacity holders because, in the pipelines' rate case, the increased revenue reduces the reservation charges firm shippers might otherwise pay. *See Associated Gas Distributors* v. *FERC* (D.C. Cir. 1987) (selective discounting by a monopolist justified on equitable grounds because it would reduce captive customers' contributions to fixed costs).

[26] Consumers Energy Company, 82 FERC] 61,284 (1997). *See* Inside FERC's Gas Market Report, December 1, 1995, at 14 (discussing various methods of avoiding the price cap).

[27] For example, in the automobile market, the time and expense of comparison shopping may result in some customers paying higher prices than others.

[28] *See* Gas Daily, February 2, 1996, at 1.

the development of an efficient short-term market.

Maximum rate regulation may have an unintended effect by reducing the capacity available during peak periods, the time at which the industry would most benefit from having as much pipeline capacity available as is possible. As a result of the maximum rate cap, firm capacity holders may not find it sufficiently profitable to make their capacity available. It may be that due to state restrictions not all local distribution companies (LDCs) may be able to make delivered gas transactions off-system. Thus, they may not make capacity available during peak periods if they cannot receive the market price for their capacity.

For instance, an LDC might have a peak shaving capability (storage or liquified natural gas (LNG)) that costs more to operate than the maximum transportation rate. The LDC might be willing to release its transportation capacity and use the peak shaving device instead if the price it could receive for pipeline transportation exceeded its cost to operate the peak shaving device. By using its peak shaving device instead of transportation, the shipper would be expanding the amount of transportation capacity available for resale during a peak period. But if the price cap prevented the shipper from obtaining a price higher than the cost of turning on the peak shaving device, and the shipper could not sell the gas on a delivered basis, the shipper would use its transportation capacity, thus depriving other shippers (without peak shaving) of the opportunity to acquire needed transportation capacity. Thus, maximum rate regulation may actually reduce the amount of pipeline capacity available for sale during peak periods. A restriction on the amount of available capacity would cause peak period prices to be higher than they would be without the cap. Comments should address whether the price cap has these effects and whether it does significantly limit the amount of capacity available in the short-term market.

Maximum rate regulation during peak periods also may increase shipper imbalances and penalties. During peak periods, penalties affect the value of transportation.[29] In a cold snap, a shipper may be willing to pay a penalty for overrunning its contract demand to obtain the gas it needs. If that shipper faced a $100/MMBtu penalty, it might be willing to pay any amount for capacity up to $100 to avoid the penalty. For example, if the value of capacity in an efficient market were $80, the shipper willing to pay a $100 penalty would be better off by $20 if it obtained capacity instead. But, as described above, the price cap may reduce the efficiency of the marketplace, limiting the shipper's ability to obtain the capacity it needs. The shipper, therefore, may choose to overrun its contract demand and pay the penalty. In this situation, the price cap may result in increasing shipper imbalances, thereby increasing the penalty revenue paid to pipelines, and perhaps decreasing the reliability of the system.

During off-peak periods, the maximum rate cap does not affect the efficiency of the market because market values do not appear to reach the maximum rate ceiling. The rate cap, however, may not provide sufficient protection against the exercise of market power. During off-peak periods, pipelines and releasing shippers are not required to sell available capacity at prices less than the maximum rate.[30] By limiting the supply of capacity during off-peak periods, pipelines or releasing shippers may be able to charge monopoly prices because even a monopoly price may be less than the daily maximum rate. Since pipelines are permitted to price discriminate at rates below the maximum rate, they may charge shippers, at least those without other choices, higher prices than would prevail in an efficient competitive market. Although the Commission has permitted pipelines to price discriminate by discounting below the maximum rate, it may be that the benefits for captive customers holding long-term transportation contracts come at too great a cost to other shippers or that the benefits even to captive customers no longer warrant continuation of this policy.

In summary, the interface between the regulated and unregulated sectors of the gas industry has become much more complicated in the last five years. Regulatory policies that worked well in one market setting may not work as well today. For this reason, the Commission is reassessing its current policies and proposing changes.

II. Proposed Change in Regulatory Approach

The Commission's regulatory policies must be attuned to the realities of the market it is regulating. As became clear during the period when wellhead prices were regulated, consumers receive little benefit from artificially low regulated prices if such prices distort the market and create shortages so consumers cannot acquire gas when they most need it.[31] Moreover, in fashioning regulatory policies, it must be recognized that market power varies over a continuum between perfect competition at one end of the continuum and a single firm monopoly with impenetrable entry barriers at the other. Thus, a regulatory approach appropriate for pure monopoly markets may not be the best method for regulating the markets where market power, while not absent, may be partially disciplined by market forces.

The changes to the short-term market raise the question of whether the Commission needs to change its regulatory philosophy. Prior to unbundling, maximum rate regulation in the short-term market was more effective, because the short-term market essentially was limited to the pipelines' interruptible transportation service.

However, as the short-term market continues to develop, the continuation of maximum rate regulation in the short-term market may become increasingly troublesome. First, maximum rate regulation, by its very nature, inefficiently allocates capacity because those shippers placing the greatest value on capacity may not be able to obtain it. Therefore, during peak periods, when the market is under the most stress, the rate cap may result in a less efficient and more opaque market in which shippers cannot acquire capacity they need or must pay higher prices for delivered gas than would have prevailed in a more efficient short-term market. Second, maximum rate regulation may not be the most effective tool for preventing the exercise of market power, particularly for transactions during off-peak periods. Thus, while the ostensible goal of Commission regulatory policy is to protect shippers against the exercise of monopoly power by the pipelines, the current system of maximum rate regulation may no longer be the best method for meeting this goal.

[29] *See* Industry Surveys the Damage as Winter's Strength Runs Out, Natural Gas Intelligence, April 22, 1996, at 1, 4 (penalties started to be a real factor in determining the price of gas in the Midwest).

[30] *See* El Paso Natural Gas Company, 83 FERC ¶ 61,286 (1998) (pipeline not required to discount below the maximum rate); *Southern California Edison Company* v. *Southern California Gas Company*, 79 FERC ¶ 61,157 (1997), *reh'g denied*, 80 FERC ¶ 61,390 (1997) (no requirement that pipelines or shippers offer discounts below the maximum rate).

[31] See *Transcontinental Gas Pipe Line Corporation* v. *State Oil and Gas Board*, 474 U.S. 409, 420 (1986) (Natural Gas Act's artificial pricing scheme is a major cause of imbalance between supply and demand); Atlantic Refining Company v. Public Service Commission of N.Y., 360 U.S. 378, 388 (1959) (rate regulation should ensure reasonable rates consistent with the maintenance of adequate service).

A. A Different Model for Regulating the Short-term Market

To respond to the emerging short-term market, the Commission is proposing in this NOPR a change in regulatory focus to better reflect the way in which short-term gas markets function and to do a better job of protecting against the exercise of market power and helping to foster a more competitive commodity market. The Commission, however, recognizes that the ability to exercise market power still exists in the short-term market and, therefore, any regulatory approach it adopts must continue to provide effective protection against the exercise of market power.

To do this, there are several criteria that a regulatory approach must satisfy. It should maximize efficient competition among releasing shippers and between releasing shippers and the pipelines, because competition and efficient markets are the best overall protection against the exercise of market power. It should include policies that will mitigate any residual market power and monitor for its continued exercise. It should fairly balance the interests of those customers that purchase long-term capacity and those who choose to acquire transportation in the short-term market. And, it should promote innovation in service offerings to attract new customers.

The Commission believes its statutory objectives can better be met by a regulatory model that recognizes the distinction between short-term and long-term markets. Therefore, in the short-term transportation market, the Commission proposes to replace the reliance on maximum rate regulation [32] with a regulatory approach focusing on creating competitive alternatives for shippers, developing policies to mitigate residual market power, and monitoring the marketplace for the exercise of market power. In the long-term transportation market, the Commission proposes to continue to rely upon regulated cost-based rates to protect against the exercise of monopoly power by the pipelines. Price regulation for the long-term transportation market will ensure continued protection for captive customers with long-term contracts with the pipeline. It will also help discipline the potential exercise of market power in the short-term market by enabling shippers to purchase long-term capacity at regulated rates.

The Commission fully recognizes that pipelines still possess monopoly power in the transportation market as a result of economies of scale and barriers to entry. This is particularly true in the long-term market where the pipeline may be the only source of capacity. The Commission also recognizes that simply because competition exists for the gas commodity at receipt and delivery points on the grid does not mean that the transportation between all points is necessarily fully competitive.

On the other hand, in the short-term market, the Commission's capacity release and flexible receipt and delivery point policies, together with other market changes such as pooling, hub and market center services, and storage services, have increased the competitive alternatives available to buyers of capacity. While these measures have not resulted in effective competition everywhere throughout the pipeline grid, it cannot be disputed that they have increased the level of competition and reduced the ability of pipelines to exercise monopoly power. Thus, while a regulatory presence is still needed in the short-term transportation market, the Commission may not need to continue to regulate this market as if each pipeline was still a single firm monopoly.

At the same time the Commission is proposing to eliminate maximum rate regulation in the short-term market, it is proposing several initiatives in this NOPR to maximize competition in the short-term market, minimize the potential for the exercise of market power, and monitor the marketplace for the continuing exercise of market power. To maximize the extent of competition, the Commission is proposing a number of measures to create more efficient competition among capacity offerings so that shippers will have more choice in obtaining capacity. The Commission is proposing to create more uniform nominating procedures for released capacity so that it can better compete with capacity from the pipelines and delivered gas transactions. The Commission further is requesting comment on whether changes in regulatory policy are needed to maximize shippers' ability to segment their capacity to provide greater competitive alternatives. To further improve competition in the short-term market across the pipeline grid, the Commission is suggesting potential methods of reforming penalty procedures to ensure that different penalty processes across pipelines do not limit shippers' flexibility in using capacity or otherwise distort shippers' decisions about how best to use capacity.

As an additional measure to mitigate potential market power, the Commission is proposing the use of capacity auctions for all short-term capacity. A properly designed capacity auction can protect against the exercise of market power by limiting the ability to withhold capacity and to engage in price discrimination.

To monitor the marketplace, the Commission is proposing to establish reporting requirements to provide capacity and pricing information to all shippers. This information will have the further benefit of making competition more efficient by providing the pricing information that a competitive market needs for shippers to make informed decisions about their capacity purchases. All of these proposals are addressed in more detail in Parts III and IV of this NOPR.

In addition to these proposals for monitoring the short-term market, the Commission proposes to conduct a generic review of the operation of the short-term market without a price cap after two winter heating seasons.

Because the proposed regulatory approach differs between short-term and long-term services, there is a need to define the period encompassed by each. The Commission is proposing to define short-term transactions as all transactions of less than one year. The Commission has traditionally drawn the line between long-term and short-term transactions at one year.[33] A term of one year corresponds with naturally repeating weather and planning cycles for production, transportation, and storage. A term of one year also corresponds with the period used to calculate long-term rates.

The Commission, however, requests comment on whether a shorter period, such as five months, should be used. If a period of less than one year were chosen, it could either be a discrete period (e.g., November through March) or could refer to any transaction with a term of less than the chosen period. A five month period, for instance, would generally correspond to the length of time of the heating season.[34] The use of a period of less than one year could reduce the outlay that any shipper would have to make in order to buy

[32] Minimum rates would be retained.

[33] 18 CFR 284.221(d)(2) (right of first refusal applies to contracts with a term of one year or more); Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, Order No. 636–A, 57 FR 36128 (Aug. 12, 1992), FERC Stats. & Regs. Regulations Preambles [Jan. 1991–June 1996] ¶ 30,950, at 30,627 (Aug. 3, 1992).

[34] In defining short-term for the purposes of capacity release transactions, the industry, through the Gas Industry Standards Board, defined short-term releases as releases of less than five months. 18 CFR 284.10(b)(1)(v), Capacity Release Related Standards 5.3.2.

capacity at cost-based rates to avoid the potential exercise of market power. [35]

B. Legal Basis for the Proposed Regulatory Change

The Commission's statutory responsibility under the Natural Gas Act (NGA) is to establish rates that are just and reasonable and that protect consumers of natural gas from the exercise of monopoly power by pipelines.[36] In addition, the Commission has the obligation, under the Wellhead Decontrol Act, to structure its regulatory framework to ''improve [the] competitive structure [of the natural gas industry] in order to maximize the benefits of [wellhead] decontrol.'' [37]

The courts have recognized that the Commission needs to be able to develop flexible pricing programs that accommodate its regulation to the needs of the marketplace. The Commission is not bound to ''use any single pricing formula'' in determining just and reasonable rates,[38] and cost-based regulation can be relaxed when the overall ''regulatory scheme'' ensures that rates are within a zone of reasonableness.[39] The case law makes clear that flexible rate regulation is permissible as long as, on balance, the benefits of the program outweigh the potential risks, and the Commission takes reasonable measures to protect against the exercise of market power, even though not every transaction would be free of market power.[40] In *Environmental Action* v. *FERC,* the court approved a flexible pricing program, which fostered efficient trading of energy and transmission service, even though the program created a risk that market power could be exercised over captive customers. Given the benefits of effective trading and the protections adopted by the Commission to limit the potential exercise of market power, the court concluded that the Commission acted reasonably in approving the program despite the potential risks.[41]

The Commission believes the model it is proposing satisfies the Commission's statutory obligations by achieving the appropriate balance between the benefits to be garnered from efficient trading in the short-term market and the protection needed against the exercise of market power. As discussed earlier, removing maximum rate regulation from the short-term market provides significant benefits by allowing markets to efficiently allocate capacity in an environment in which cost-based solutions do not accommodate the volatile price changes in the industry.

The potential risk of this approach is that it could give pipelines or shippers greater latitude to exercise market power during peak periods. Although competition clearly has increased in the short-term market, the Commission is not making a finding that the short-term market is sufficiently competitive to satisfy its traditional market power analysis. Nor is the Commission making a finding that the proposals in this NOPR will necessarily create a fully competitive market. Rather, as discussed below, the proposed approach in this NOPR is intended to place effective limits on the ability of pipelines and shippers to exercise market power by enhancing competitive options in the short-term market, mitigating market power by limiting the ability to withhold capacity and price discriminate, and monitoring the marketplace.

The proposed approach should provide benefits to all shippers—both those holding long-term capacity, and those purchasing short-term capacity. Long-term capacity holders would still be protected by the cost-based rate in the long-term market and would benefit by being able to realize the value of their long-term capacity. Shippers relying on the short-term market would not be unreasonably harmed since the proposals in the NOPR are designed to protect them against the withholding of capacity and price discrimination, both during peak and off-peak periods. At the same time, short-term shippers would benefit because the proposals would help to create a more efficient marketplace during peak periods, with capacity allocated to those valuing it most, prices undistorted by regulatory allocation priorities, clearer price signals, and more open, transparent, and efficient capacity allocations. These benefits are fully described below.

The approach proposed here also appears better suited than other potential approaches for responding to the changing dynamics of the short-term market. The Commission, however, requests comment on whether this proposal is the best approach for protecting against market power given the realities of the short-term market. Commenters should address whether the Commission should seek evidence to determine whether it can make a finding that the market is competitive or pursue other regulatory approaches.

1. Protection Against the Exercise of Market Power by Pipelines and Shippers

The Commission's primary responsibility is to protect against the exercise of monopoly power by pipelines. Even under the current maximum rate approach, such protection is not absolute. Pipelines are able to price discriminate below the existing price cap.

The approach proposed here seeks to control the pipelines' exercise of monopoly power in a different way, by enhancing the competition from firm shippers releasing capacity, by requiring pipeline capacity to be sold through an auction that limits the ability to withhold capacity, and by monitoring the marketplace for evidence of the exercise of monopoly power. Moreover, the proposed approach would reduce the ability of pipelines to withhold future capacity (by not expanding their systems) in order to increase price and earn a supra-competitive rate of return. If pipelines sought to limit capacity in order to earn high returns on short-term transactions, shippers could purchase long-term capacity at cost-based rates and capture the profit opportunities in the short-term market for themselves by releasing the capacity. Further, any revenues from short-term sales would be accounted for in the pipeline's next rate case ensuring that the long-term benefits of increased revenue from sales of short-term capacity go to the long-term firm capacity holders. The Commission also could act under section 5 of the NGA in cases where monitoring revealed that

[35] For instance, under a five month definition, the maximum charge a shipper would have to incur to purchase long-term capacity would be the current monthly rate times five.

[36] *FPC* v. *Hope Natural Gas Co.,* 320 U.S. 591, 610 (1944); *Associated Gas Distributors* v. *FERC,* 824 F.2d 981, 995 (D.C. Cir. 1987), *cert. denied,* 485 U.S. 1006 (1988) (''The Natural Gas Act has the fundamental purpose of protecting interstate gas consumers from pipelines' monopoly power.'').

[37] Natural Gas Decontrol Act of 1989, H.R. Rep. No. 101–29, 101st Cong., 1st Sess., at 6 (1989); Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations, Order No. 636, 57 FR 13267 (Apr. 16, 1992), FERC Stats. & Regs. Regulations Preambles [Jan. 1991–June 1996] ¶ 30,939, at 30,932 (Apr. 8, 1992).

[38] *Elizabethtown Gas Company* v. *FERC,* 10 F.3d 866, 870 (D.C. Cir. 1993) (approving market-based rates).

[39] *See Farmers Union Central Exchange* v. *FERC,* 734 F.2d 1486, 1509–10 (D.C. Cir. 1984).

[40] *Environmental Action* v. *FERC,* 996 F.2d 401, 408, 411 (D.C. Cir. 1993) (approving flexible pricing program to permit efficient trading of electric power).

[41] As the court stated:

We acknowledge that the flexible pricing that fosters trading among members of the Pool also permits price discrimination especially against captive utilities. Yet, given the benefits of this trading, the limited number of captive members, and the provisions for monitoring transactions and remedying any abuses of market power, we do not find that the Commission acted arbitrarily when it approved the use of flexible prices despite their admitted risk.

996 F.2d at 411.

the market rate is not just and reasonable.[42]

The approach proposed here also can be expected to limit the exercise of market power by firm capacity holders. Releasing shippers face competition from other releasing shippers and from the sale of pipeline firm and interruptible service. Firm capacity holders should not be able to withhold capacity to raise price, because if they do not use their capacity it then becomes available either as interruptible or short-term firm capacity from the pipeline. The proposed auction would then require the pipeline to sell that capacity at a market-determined price. The auction also would limit the ability of firm capacity holders to unduly discriminate. Moreover, the pipelines' ability to build additional capacity is a final protection against releasing shippers' exercise of market power. If the pipeline observes shippers earning high returns from constrained capacity, the pipelines have every incentive to try to capture those returns by building additional capacity to satisfy that demand.

2. Protection for Shippers Relying on Long-term and Short-term Capacity

While the Commission has an obligation to consider the interests of all shippers, its paramount obligation is to protect long-term firm capacity holders that cannot risk going without long-term capacity.[43] Interruptible or short-term shippers, by definition, take the risk that they may be unable to acquire capacity.[44] The proposed regulatory model would protect those shippers holding long-term capacity, while at the same time not putting short-term shippers at unreasonable risk and perhaps even providing them with benefits.

Under the proposed approach, shippers holding long-term capacity would continue to receive the traditional protection accorded them because long-term capacity would still be subject to cost-based regulation. Indeed, removal of the price cap for short-term transactions should benefit long-term capacity holders, because it would permit them to recover more of their reservation charges during peak periods. For those shippers holding long-term contracts that are unable to sell delivered gas, the price cap currently limits their ability to recover their reservation charges by releasing capacity during peak periods when capacity is valuable. On the other hand, during off-peak periods, competition from other releasers or the pipeline may limit a shipper's ability to recover its reservation charges. At the same time, interruptible or short-term shippers benefit from the competition during off-peak periods because they pay prices lower than what the pipeline charged when it was the sole supplier of capacity. Thus, removal of the rate cap would permit long-term firm capacity holders to realize the full value of their transportation capacity during both peak and off-peak periods.

Even if a long-term firm capacity holder is unable to release its own capacity during a peak period, it may benefit if the pipeline can charge competitive rates for peak period capacity. In the pipeline's next rate case, the revenue received from such sales would be used to reduce the reservation charges for firm customers.

Nonetheless, the Commission expects that the proposed regulatory model would not put shippers in the short-term market at unreasonable risk and may even benefit them. These shippers would have the option of buying long-term capacity at regulated cost-based rates, which should help to limit the potential exercise of market power in the short-term market. Pipelines would continue to be required to sell long-term capacity to anyone offering the maximum rate regardless of the rates bid for short-term capacity. Further, to ensure that long-term capacity is available, the Commission would examine closely pipeline refusals to construct taps requested by customers as well as pipeline refusals to construct new capacity when demand for new construction exists.

This model also should work to the benefit of short-term customers during both off-peak and peak periods. During peak periods, the price cap offers only limited protection against the exercise of market power, and may actually create inefficiency which reduces short-term shippers' ability to obtain capacity when they need it. During peak periods, when capacity is constrained, short-term customers currently run a significant risk that they may be unable to obtain capacity from the pipeline even if they place the highest value on that capacity. If they instead seek to acquire capacity through a delivered gas transaction, they receive little protection against the exercise of market power and the price for such gas may be higher than it would be in a more efficient market. By removing the price cap, but at the same time offering initiatives for enhancing competition among capacity alternatives, the approach proposed in this NOPR should be more effective than the current system in creating a transparent and efficient short-term market in which shippers, even on peak, can acquire gas and capacity at efficient market-clearing prices.

During off-peak periods, the rate cap provides little protection against the exercise of market power, because pipelines and shippers are not required to sell capacity at rates below the maximum rate. The proposals for increasing competition and the auction ought to limit the pipelines' ability to exercise market power or price discriminate so all short-term shippers would be paying prices closer to a competitive level.

3. Alternative Approaches for Regulating the Short-Term Transportation Market

The approach proposed in this NOPR appears better suited than other possible methods of dealing with the dynamics of the short-term transportation market.

An alternative approach would be to continue the current maximum rate system, but allow pipelines and firm capacity holders to seek removal of the cap in the short-term market upon a demonstration that they cannot exercise market power. In effect, this approach presumes market power is present and requires the parties to try to predict, through market concentration data or other approaches, whether market power will be exercised if the rate cap is removed. This is essentially the approach the Commission uses with respect to market power in its Alternative Rate Design policy, which focuses on the exercise of market power in the long-term market for pipeline capacity.[45]

The approach of screening for market power is certainly a possible alternative, but it would move the Commission in a direction very different from the one

[42] *See* Elizabethtown, 10 F.3d at 870 (Commission can use its section 5 authority to assure that market-based rates are just and reasonable); Environmental Action, 996 F.2d at 411 (emphasizing provisions for monitoring market-based rates to protect against exercise of market power).

[43] *See Maryland People's Counsel* v. *FERC,* 761 F.2d 768 (D.C. Cir. 1985); *Maryland People's Counsel* v. *FERC,* 761 F.2d 780 (D.C. Cir. 1985) (remanding special marketing program because it excluded core captive customers); Environmental Action, 761 F.2d at 411 (permitting flexible pricing program even though there was some possibility of discrimination against captive utilities).

[44] *See American Gas Association* v. *FERC,* 912 F.2d 1496, 1518 (D.C. Cir. 1990). The court remanded the Commission's decision to permit pre-granted abandonment of all long-term contracts, because of a concern about the pipeline's ability to exercise monopoly market power over long-term capacity holders. The court, however, found that holders of interruptible and short-term services did not need similar protection against the exercise of pipeline monopoly power.

[45] Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, and Regulation of Negotiated Transportation Services of Natural Gas Pipelines, 61 FR 4633 (Feb. 7, 1996), 74 FERC ¶ 61,076 (1996).

proposed here. The approach proposed here does not rely on a finding of a lack of market power, relying instead on regulatory measures to reduce or limit the exercise of market power.

The market power screen, in contrast, would require the Commission to make a finding of lack of market power in each relevant market. This not only could be a time consuming and daunting task to undertake on an industry-wide basis, but it might have to be repeated periodically as contracts expire or the competitive circumstances on individual pipelines change. The market power screen approach also was developed to isolate market power in circumstances in which the pipeline is the sole source of capacity, and it, therefore, imposes a relatively heavy evidentiary burden on pipelines seeking market-based rates. Such a screen may not be discriminating enough or the most appropriate means of dealing with market power in the short-term market where more competition is clearly present. The use of the traditional market power screen, therefore, might suggest the presence of market power in areas that ought to be found reasonably competitive.

Moreover, in cases where the concentration data do not satisfy the market power screen, the market analysis approach would continue to rely on maximum rate regulation which, as discussed earlier, may not be very effective in protecting against market power in the short-term market and also promotes more inefficient short-term markets. The Commission, however, requests comment on whether a modified version of the market power screen could and should be developed for the short-term market that would be easier to administer and could determine whether market power is a significant problem.

Another cost-of-service option would be to attempt to develop a cost-based, seasonal rate design that would better approximate pricing activity that would occur during peak and off-peak periods. But price swings can be very large on a daily, weekly, or monthly basis, making the development of a rate structure that would accurately reflect competitive market conditions particularly difficult. Moreover, if the price cap is raised high enough to accommodate peak period competitive prices, this approach is little different than simply removing the rate cap, since it would afford firms with market power substantial latitude to exercise that power at prices below the price cap.[46]

Of the regulatory options available, the proposed regulatory model appears to create the best balance between achieving the Commission's objectives of preventing the exercise of market power and creating a regulatory environment that fosters a competitive, efficient commodity market that is fair to all shippers. This approach would free the short-term market from regulatory impediments that prevent the market from responding to the competitive supply and demand forces that may result in competitive prices exceeding the price cap. At the same time, the proposals to increase competition in the short-term market should help to keep the prices for most transactions within reasonable levels. Because firm shippers would be better able to release capacity in competition with the pipelines, the pipelines' ability to exercise market power would be limited. At the same time, firm shippers' ability to exercise market power would be restrained because, if they tried to withhold capacity to raise prices, the pipelines would be required to sell that capacity at market clearing prices. The proposed auction also would restrain the ability of both pipelines and firm shippers to exercise market power and to unduly discriminate in the allocation of capacity. Further, the overall scheme of the proposal limits the pipelines' ability to charge monopoly prices because shippers can discipline the pipelines' exercise of market power by purchasing long-term capacity at cost-based levels.

C. Interrelated Proposals for Regulatory Change

The principal focus of the regulatory changes proposed in this NOPR is on improving efficiency and competition in the short-term transportation market. Yet, the regulation of long-term transportation service is an integral part of the Commission's proposal because continued regulation of long-term services is an important back-stop to protect against the pipelines' exercise of market power. Long-term and short-term transportation services are linked in other ways since the value of purchasing long-term capacity lies in its ability to insure shippers against the risk of price swings in the short-term market. Thus, the changing nature of short-term markets has a concomitant effect on how shippers use the long-term market and, likewise, actions affecting long-term contracts can affect the short-term market. For example, if a pipeline can attract more shippers to its system, the long-term rate will be reduced, which, in turn, would limit the ability of pipelines to raise price in the short-term market. On the other hand, policies discouraging shippers from entering long-term contracts could reduce the extent of competition in the short-term market. Because of the relationship between short-term and long-term services, the Commission also is proposing in this NOPR initiatives to improve competition and innovation in the market for long-term services and to ensure that its regulatory policies in the long-term market do not bias shippers' purchasing decisions.

The Commission is proposing to give pipelines more flexibility in negotiating rates and terms of service with individual shippers. Allowing greater flexibility in contract terms for long-term service can be an important element in the allocation of risk between pipelines and potential customers. Permitting negotiation of services will provide an incentive for pipelines to innovate and create additional value in transportation service.[47] Also, negotiated rates and services may permit the pipelines to attract new customers, which would reduce reservation charges for existing customers.

On the other hand, allowing the pipelines to negotiate individual terms of service creates the possibility of discrimination against captive customers as well as a risk that such terms could degrade competition in the short-term market by limiting the range of capacity alternatives available to shippers. To fully realize the benefits from negotiated services while reducing the risks, the Commission is proposing to permit pipelines and shippers to enter into contracts for negotiated services, while also proposing criteria to protect against the risks of undue discrimination or impairment of the competitiveness of the short-term market.

Further, to ensure that contracting decisions are made efficiently, regulatory policies should not unfairly bias shippers' contracting decisions. Some Commission policies, like the right of first refusal, may well create an asymmetry in the risks facing pipelines and capacity purchasers and bias shippers towards shorter term contracts. The Commission, therefore, is proposing certain changes in regulatory policy to

[46] *See* Environmental Action, 996 F.2d 401 (approving a flexible pricing program for an electric power pool with a rate ceiling based on the most valuable and expensive transportation service).

[47] In unregulated and even in regulated industries, sellers often create innovative service options for individual customers while still providing a basic service to all. For instance, telecommunication firms provide specialized services for small and large businesses while still providing standard service to the public.

eliminate provisions that may tilt shipper decisions towards the purchase of short-term capacity.

The construction of new capacity also affects competition in the short-term market. For instance, the ability of shippers to purchase long-term capacity at cost-based rates is a protection against the exercise of market power in the short-term market. The Commission is, therefore, considering changes in certificate policy so that these policies do not unnecessarily inhibit competition.

In addition, to better reflect the changing nature of services in the short-term market and to consolidate pipeline reporting requirements under Part 284, the Commission is proposing to reorganize Part 284 to put the regulations into a more logical order.[48]

III. Creating Greater Competition Among Short-Term Service Offerings

Increasing competition is the best antidote to market power. As long as buyers have good alternative sources of capacity, no seller can exercise market power, because any attempt to raise price above the competitive level will result in the buyer moving to another seller.[49] Prior to Order No. 636, the pipeline was the only source of both long-term and short-term capacity. The Commission's establishment, in Order No. 636, of the capacity release mechanism has significantly increased competition on most pipelines both between the pipeline and shippers and among shippers themselves.

But there remain means of enhancing competition and improving the substitutability of capacity alternatives. Three such improvements are to make nomination and scheduling procedures more uniform for all short-term services; provide shippers with a greater ability to segment capacity and use alternate receipt and delivery points so transportation alternatives are more comparable; and employ auctions for all capacity to limit the ability of pipelines or shippers to withhold capacity or discriminate. In addition, the Commission is proposing changes to its reporting requirements to ensure that comparable information about pipeline and release transactions is provided. Improved information enables shippers to make more informed capacity choices while it also permits the Commission and the industry to monitor transactions for the potential exercise of market power in the event the Commission's efforts to mitigate market power are not successful. The Commission is committed to take appropriate and timely action in individual cases to deal with the exercise of market power. To this end, the Commission is in the process of considering improvements to its procedures for handling complaints.[50]

A. Nomination Equality

In order to foster a more competitive short-term market, all forms of transportation—pipeline interruptible and short-term firm capacity, released capacity, and delivered sales transactions—must be able to compete on as equal a basis as possible. While there are obviously differences in rights associated with the different types of capacity, the Commission is concerned that differences in nomination and scheduling procedures for capacity release inhibit the ability of capacity release transactions to compete with pipeline capacity. The Commission, however, requests comment on whether the existing differences in nomination and scheduling procedures for capacity release transactions reflect important differences in the nature of the services that should be preserved.

Under current regulations, pipelines can sell their interruptible and short-term services at any time and shippers can schedule such services at the earliest available nomination opportunity. Similarly, capacity holders making delivered sales can nominate and schedule at every available opportunity. In contrast, nomination and scheduling opportunities under capacity release transactions currently are significantly circumscribed.

Under Commission regulations, shippers currently submit their daily nominations at 11:30 a.m. to take effect at 9 a.m. the next gas day. Pipelines presently are required to provide shippers at least one intra-day nomination change after the 11:30 a.m. nomination, although many pipelines provide additional intra-day nomination opportunities. While a pipeline may sell interruptible or short-term firm service and permit the recipient of that service to submit a nomination at the earliest available nomination opportunity, shippers consummating a release transaction must do so prior to 9 a.m. and can only submit a nomination at 11:30 a.m. for the next gas day. They cannot consummate a release transaction later than 9 a.m., nor can the replacement shipper utilize an intra-day nomination opportunity to submit a nomination for the current gas day.

The disparate treatment of capacity release transactions, if left uncorrected, promises to become even more severe as a result of the industry's agreement to enhance intra-day nomination opportunities. In a final rule issued on July 15, 1998,[51] the Commission adopted the consensus agreement of the Gas Industry Standards Board (GISB) to expand shippers' intra-day nomination opportunities by establishing three synchronized intra-day nomination periods across the grid. Under the industry's schedule, the three synchronization times are 6 p.m. (for the next gas day), 10 a.m. and 5 p.m. (for the current gas day). A shipper obtaining short-term firm or interruptible capacity from the pipeline, or making a delivered sales transaction, will be able to submit a nomination at any of these intra-day nomination opportunities. Significantly, however, a replacement shipper cannot acquire released capacity immediately prior to these intra-day nomination times and nominate at these times. The replacement shipper must consummate a capacity release deal by 9 a.m. and must wait a full day before it can flow gas under the release transaction.

In order to place capacity release transactions on a more equal footing with pipeline services, the Commission is proposing, in proposed section 284.13(c)(1)(ii), that pipelines provide purchasers of released capacity, like shippers purchasing capacity from the pipeline, with the opportunity to submit a nomination at the first available opportunity after consummation of the deal. This will enable shippers, for instance, to acquire released capacity at any of the nomination or intra-day nomination synchronization times and nominate gas coincident with their acquisition of capacity.

In some cases, pipelines currently require replacement shippers to pass a credit-worthiness check and execute contracts prior to nominating. Under the proposed regulation, such requirements could not prevent a replacement shipper from nominating when it completes the release transaction. Proposed section 284.13(c)(1)(ii) would provide that a pipeline that requires the replacement shipper to enter into a contract must

[48] The references in this NOPR to proposed regulatory changes are to the new regulatory sections. References to existing regulations are to the existing regulatory framework.

[49] Market power can be exercised in two ways. A holder of capacity may withhold capacity from the market to drive up the price that all shippers pay for the remaining capacity, or it can price discriminate by charging captive customers more than those customers with more alternatives. In either case, however, competition will prevent the exercise of market power.

[50] *See* Compliant Procedures, Docket No. RM98–13–000 (issued contemporaneously with this NOPR).

[51] Standards For Business Practices Of Interstate Natural Gas Pipelines, Final Rule, 63 FR 39509 (July 23, 1998), 84 FERC ¶ 61,031 (Jul. 15, 1998).

issue the contract within one hour of submission of the transaction [52] and that the requirement for contracting must not inhibit the ability to submit a nomination at the time the transaction is complete.

Pipelines have available several procedures which they can use to protect themselves against the credit risk of the replacement shipper. The pipelines can institute procedures under which replacement shippers receive pre-approval of their credit-worthiness or receive a master contract, like those used for interruptible shippers, permitting the replacement shipper to nominate under that contract at any time.[53] For replacement shippers that do not have a master contract, the pipeline could provide a contract number for nominating as soon as the pipeline is notified of the release transaction. For replacement shippers that have not received pre-approved credit, the releasing shipper may agree to be liable for any usage charges incurred by the replacement shipper while the pipeline conducts the credit-worthiness check.[54]

B. Segmentation and Flexibility of Receipt and Delivery Points

1. Background

In Order No. 636, the Commission established two principles that are important to creating efficient competition between holders of capacity and the pipelines: segmentation of capacity and the ability of shippers to use alternative receipt and delivery points. Segmentation refers to the ability of firm capacity holders to subdivide their capacity into segments to enhance the value of the capacity and the capacity holders' ability to compete with the pipeline. In the example used in Order No. 636, a shipper holding firm capacity from a primary receipt point in the Gulf of Mexico to primary delivery points in New York could release that capacity to a replacement shipper moving gas from the Gulf to Atlanta while the New York releasing shipper could inject gas downstream of Atlanta and use the remainder of the capacity to deliver the gas to New York. In order for such a transaction to work, both the releasing and replacement shippers need the right to change their receipt and delivery points from the primary points in their contract to use other available points.

Without the ability to segment and use alternate points, the New York releasing shipper in the example would not be an effective competitor to another shipper holding firm primary point capacity at Atlanta. The ability to segment capacity and use alternate points, therefore, provides a potential replacement shipper who wants to ship to Atlanta with additional capacity options. It can buy from the releasing shipper holding primary point capacity in Atlanta or from the New York releasing shipper or any other shipper holding capacity downstream of Atlanta.

However, under current Commission policies, the ability of the releasing shipper in New York to compete with the pipeline or with the shipper in Atlanta may be limited. Under the Commission's current policies, the releasing shipper in New York only has a secondary delivery point right at Atlanta, which is inferior to the primary point right of the releasing shipper holding primary point rights at Atlanta. In other words, if the pipeline is unable to make both deliveries to Atlanta, the shipper with the primary right at Atlanta will be given delivery priority over the releasing shipper in New York or the replacement shipper buying capacity from the New York shipper, each of which only has secondary point rights at Atlanta. To the extent that this is a possibility, capacity from the releasing shipper in New York is not equal in quality or fully competitive with the capacity from the shipper holding primary point rights at Atlanta.

Receipt and delivery point flexibility is not applied consistently across pipelines, and pipelines do not treat different types of segmentation similarly. During the restructuring proceedings mandated by Order No. 636, the Commission permitted certain pipelines to adopt tariff provisions under which releasing shippers would lose their rights to primary receipt or delivery points if replacement shippers changed primary points under the release.[55] The Commission permitted such restrictions where the pipelines had pre-existing tariff provisions that did not permit shippers' primary receipt and delivery point CD rights to exceed their mainline rights. To prevent the possible loss of primary point rights, the releasing shipper would have to include a condition in the release prohibiting the replacement shipper from changing primary points. The Commission, however, sought to minimize the effect of this restriction on segmented releases by adopting a policy for segmented releases under which:

> the releasing and replacement shippers must be treated as separate shippers with separate contract demands. Thus, the releasing shipper may reserve primary points on the unreleased segment up to its capacity entitlement on that segment, while the replacement shipper simultaneously reserves primary points on the released segment up to its capacity on that segment.[56]

Under this policy [hereinafter referred to as the *Texas Eastern/El Paso* policy], the releasing shipper could protect its delivery point rights by choosing Atlanta as its primary receipt point and New York as its primary delivery point, while the replacement shipper designate its primary receipt point as the Gulf and Atlanta as its primary delivery point. However, it is not clear whether all pipelines adhere to this policy.[57]

Even on those pipelines following the *Texas Eastern/El Paso* policy, replacement shippers face limitations on their ability to change primary receipt and delivery points.[58] However, even at the time the Commission permitted those pipelines with pre-existing tariff restrictions on receipt and delivery point rights to continue such restrictions, it was skeptical about the justifications for imposing such limits.[59] In fact, the Commission rejected applications to impose similar

[52] The current regulations require pipelines to issue contracts within one hour. 18 CFR 284.10(b)(1)(v), Capacity Release Related Standards 5.3.2.

[53] The Commission previously issued a proposed rule suggesting that pipelines use pre-approved credit-worthiness procedures for replacement shippers. Secondary Market Transactions on Interstate Natural Gas Pipelines, Notice of Proposed Rulemaking, 61 FR 41046 (Aug. 7, 1996), IV FERC Stats. & Regs. Proposed Regulations ¶ 32,520 (Jul. 31, 1996). In the comments on the proposal, the pipelines, in general, did not object to the use of pre-approval for credit-worthiness or master contracts. Tenneco Energy objected only to the use of master contracts, arguing that because capacity release is a firm service, the pipeline needs prior notice of the specific terms of the release including the firm transportation quantity, the zones of the release, and the rights to primary and secondary points.

[54] Releasing shippers already are responsible for all reservation charges under the Commission's capacity release regulations. 18 CFR 284.243(f).

[55] *See* Transwestern Pipeline Company, 62 FERC at 61,659, 63 FERC at 61,911–12 (1993); El Paso Natural Gas Company, 62 FERC ¶ 61,311, at 62,982–83 (1993).

[56] Texas Eastern Transmission Corporation, 63 FERC ¶ 61,100, at 61,452 (1993). El Paso Natural Gas Company, 62 FERC ¶ 63,311, at 62,991. *See also* Transwestern Pipeline Company, 61 FERC ¶ 61,332, at 62,232 (1992).

[57] *See* Colorado Interstate Gas Company FERC Gas Tariff, First Revised Volume No. 1, Third Revised Sheet No. 254 (replacement shippers are not permitted to change primary points and can nominate only the original primary or at secondary points).

[58] For example, if the replacement shipper seeks to change its primary receipt point right from the Gulf to another point, then the releasing New York shipper might lose the ability to return to its primary Gulf receipt point at the end of the release.

[59] *See* Transwestern Pipeline Company, 62 FERC at 61,659, 63 FERC at 61,911–12 (1993); El Paso Natural Gas Company, 62 FERC ¶ 61,311, at 62,982–83 (1993).

restrictions by pipelines without pre-existing restrictions.[60] In these cases, the Commission required pipelines to permit replacement shippers to change primary points without releasing shippers losing their right to return to their original primary point at the end of the release. As the Commission explained in *Northwest*:

> Northwest's restriction on replacement shippers' ability to designate primary receipt or delivery points different from those of the releasing shipper unless the releasing shipper agrees to relinquish the original primary point could operate to limit or impair capacity release transactions. A releasing shipper may be unwilling to enter into a short term release if, in so doing, it loses priority to its primary receipt and delivery points for the remainder of a 20 year contract. Replacement shippers may be reluctant to bid on mainline capacity if they cannot be assured of receipt and delivery point capacity at available points (not subject to bumping by shippers coming later in time).[61]

Under both the *Texas Eastern/El Paso* and *Northwest* policies, replacement shippers can change primary points only if the new point is available and is not fully subscribed. In addition, shippers can only change to available points that are within the capacity path for which they paid. Pipelines, therefore, are not required to permit shippers to change primary points if doing so would mean that the pipeline's mainline capacity would be oversubscribed.

During the restructuring proceedings, the Commission addressed segmentation only in the context of release transactions. It did not address whether a shipper could segment capacity, for instance, by delivering gas to Atlanta and then shipping to New York for its own use. It is not clear whether pipelines permit such transactions. Even if pipelines do permit the segmented transaction, the shipper may be unable to designate both Atlanta and New York as primary delivery points.

In the Commission's NOPR on secondary market transactions (Secondary Market NOPR),[62] the Commission requested comment on whether it needed to provide more flexibility for shippers and replacement shippers to change primary points. Most shippers supported providing more flexibility, arguing that a shipper using capacity on a secondary basis within the primary path has the same rights afforded transportation between primary points. The pipelines, however, opposed increased flexibility, arguing that allowing releasing shippers to return to previously vacated points would require the pipeline to hold otherwise available capacity in reserve for shippers without collecting reservation charges for that capacity.

2. Is There a Need To Revise Policies To Improve Competition Between Primary and Alternate Point Capacity?

Shippers' rights to segment and use receipt and delivery points clearly differ across pipelines. In today's gas market, shippers are acquiring capacity from multiple sources and need the ability to use their capacity more flexibly. The issue is whether, in operation, the current system fairly allocates capacity so no changes need to be made to the policies or whether changes are necessary to maximize the extent of competition in the short-term market. The concerns involve two interrelated areas: segmentation policy, including priorities for primary and secondary points, and the confirmation process between pipelines and between pipelines and other entities, such as LDCs.

The first concern, as discussed above, is whether on some pipelines, replacement shippers may be unable to use certain receipt or delivery points as primary points under segmented release transactions and whether this significantly limits shippers' flexibility or raises transaction costs. These limitations would be more severe on pipelines that do not follow the *Texas Eastern/El Paso* policy by permitting both releasing shippers and replacement shippers on segmented releases to hold primary point capacity equal to their contract demand.

On some pipelines, delivery or receipt point priorities may be used to determine priorities over constrained mainline capacity even if both shippers have equal firm rights over the constrained mainline. For example, if pipelines are unable to schedule competing firm nominations, the pipelines may give higher priority to shippers moving between primary firm points over shippers moving to secondary points even if both sets of shippers have equal firm rights past the area that has become constrained.[63] It is not clear how frequently pipelines use receipt or delivery point priority to allocate mainline capacity in the event of constraints or whether the use of such an allocation policy significantly limits shippers' flexibility.

Second, confirmation practices may affect the allocation of primary and secondary capacity at interconnects between two pipelines (which includes interconnects between interstate and intrastate pipelines and interstate pipelines and local distribution companies). Suppose there are two shippers with firm capacity on pipeline A that covers an interconnect with pipeline B, but shipper 1 holds the interconnect as a primary delivery point and shipper 2 as a secondary delivery point. Further, suppose there is insufficient capacity to effect both deliveries and shipper 1 holds only interruptible capacity on pipeline B, while shipper 2 holds firm capacity on pipeline B.

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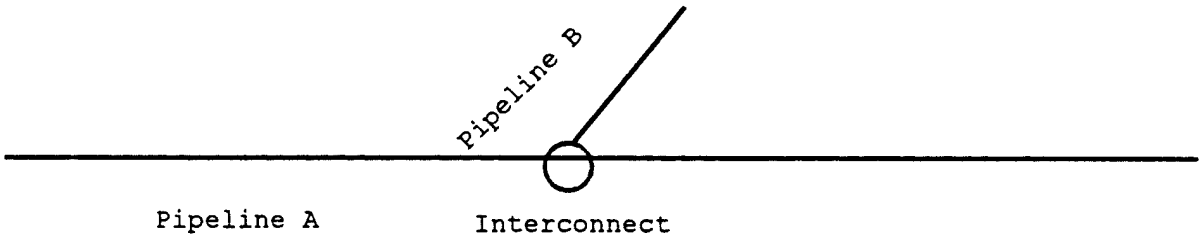

[60] *See* Northwest Pipeline Company, 63 FERC ¶ 61,124, at 61,806–08 n.72 (1993).

[61] Northwest Pipeline Company, 63 FERC ¶ 61,124, at 61,807 (1993). *See also* Questar Pipeline Company, 62 FERC ¶ 61,192, at 62,306 (1993).

[62] Secondary Market Transactions on Interstate Natural Gas Pipelines, Notice of Proposed Rulemaking, 61 FR 41046 (Aug. 7, 1996), IV FERC Stats. & Regs. Proposed Regulations ¶ 32,520 (Jul. 31, 1996).

[63] *See* El Paso Natural Gas Company, 81 FERC ¶ 61,174 (1997) (because the pipeline does not assign receipt point rights, it effectively allocates constrained mainline capacity based on whether customers are nominating to primary or secondary delivery points).

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Shipper 1: Pipeline A—Firm Primary at Delivery Point; Pipeline B—Interruptible at Receipt Point

Shipper 2: Pipeline A—Firm Secondary at Delivery Point; Pipeline B—Firm Secondary at Receipt Point

If both pipelines independently allocate capacity according to their tariff-based priorities before seeking confirmation, neither shipper would be able to flow, even though shipper 2 has firm capacity on both pipelines.[64]

In some contexts, however, gas flows may be determined by the decision of the downstream party as to which gas it will accept.[65] If that were the case in the above example, shipper 2 would flow gas because it had the priority right on downstream pipeline B.

The confirmation practices of pipelines in this situation are not specified in Commission regulations or pipeline tariffs. Thus, the result in this situation is not predictable, which may raise the costs of doing business.

The Commission is seeking comment on whether the current system works efficiently or whether changes to the current practices are needed. The comments should focus on: (1) How the current system works, particularly with respect to any differences between interconnections between pipelines and interconnections between pipelines and LDCs; (2) whether the current system impedes efficient competition and flexibility or raises transaction costs, and if so, whether the problem results from current Commission policies, from a failure to understand and adhere to those policies, or from a lack of uniform application of Commission policies; and (3) whether changes in policies would help to enhance competition and reduce the ability of pipelines or shippers to exercise market power. To help focus comments, the Commission will lay out below some options which commenters can consider. The first set of options deal with segmentation and receipt and delivery point priority issues, while the second deals with issues relating to pipeline confirmation procedures.

First, the current system under which receipt and delivery point priorities are determined on a pipeline-by-pipeline basis could continue. This option would be appropriate if current policies do not unfairly restrict competition or if non-uniform rules are necessary due to pipelines' differing operational capabilities.

Second, all pipelines could be required to conform to the *Texas Eastern/El Paso* requirement that, in a segmented release, both releasing shippers and replacement shippers can designate available primary receipt and delivery point capacity rights equal to their contract demand. This would help to increase efficient competition by giving buyers a better opportunity to substitute capacity acquired through segmented releases for pipeline capacity or capacity provided by a shipper with primary point capacity.

Third, to further expand the extent of efficient competition, all pipelines could be required to adhere to the *Northwest* approach under which replacement shippers could change primary point rights to any available point without the releasing shippers losing their right to return to their initial primary point at the end of the release. The pipeline could still sell the vacated point to another shipper during the term of the release. The *Northwest* policy also could be extended beyond release situations to permit a shipper to segment its own capacity. As described earlier, a shipper with firm capacity with a primary receipt point in the Gulf of Mexico and a primary delivery point to New York would be able to deliver gas to Atlanta as a primary delivery point, while choosing a receipt point downstream of Atlanta as a primary receipt point for making a delivery to New York as a primary delivery point.

Fourth, pipelines could be required to provide all shippers with firm capacity rights over the mainline with equal rights to flow gas past a mainline constraint point.[66] This would increase shipper capacity options by giving released capacity flowing to secondary points priority at a mainline constraint point along the shipper's path equal to pipeline capacity or released capacity flowing to primary points.

This principle could be expanded so that all shippers with firm capacity would have equal rights to receive or deliver gas at all points along their path. This would provide a shipper moving to a secondary delivery point along its path rights to deliver at that point equal to shippers buying pipeline capacity or shippers buying released capacity which have that point as a primary delivery point. Such an approach would ensure that all capacity along the mainline path would compete equally, giving shippers seeking capacity more capacity alternatives from which to choose. A possible conflict might arise if the receipt or delivery point could not accommodate all the receipts or deliveries sought by the shippers. It is not clear how frequently such a problem would occur.

Fifth, a monetary value could be developed for all receipt and delivery points so that shippers could choose to pay for additional primary point rights, especially those outside their contract path. Under this approach, shippers would be able to buy unsubscribed primary receipt and delivery point rights independent of mainline transportation. One issue under this approach would be to determine a value for additional receipt and delivery point rights. One option is to take a strictly cost-based approach in which the pipelines would have to establish the cost of making or receiving deliveries. Another might be to conduct an auction for all available points.

The previous options deal with ways of enhancing the ability of shippers with mainline capacity at secondary points to compete with capacity from the pipeline or other shippers at primary points, but do not address confirmation practices across interconnect points. One possible approach would be for the pipelines to seek to confirm all transactions before they apply tariff-based priority rules, and to require that, in the confirmation process, pipelines must seek to maximize the flow of firm transportation across an interconnect. Thus, in the example given above, shipper 2 holding firm capacity on both the upstream and downstream pipeline would get priority over shipper 1, since shipper 1 holds only interruptible transportation on the downstream pipeline.[67]/ Another potential option would be for priority through pipeline interconnect points to be determined based on which shipper has the take-away capacity on the downstream pipeline. The Commission requests comment on these options as well as the submission of other proposals for handling confirmations that would create greater substitutability between primary and secondary releases and lower the associated transactions costs

[64] Pipeline A would allocate the delivery point right to shipper 1, whose primary firm right has priority over shipper 2's secondary firm right. Pipeline B would allocate the receipt point right to shipper 2, whose firm capacity right has priority over shipper 1's interruptible capacity. Thus, the capacity allocations would not match and neither would be confirmed.

[65] See, e.g., *Southwest Gas Corporation* v. *El Paso Natural Gas Company*, 63 FERC ¶ 61,111 (1993) (finding that allocation of delivery point rights had not abrogated Southwest's delivery point priority since Southwest controlled the capacity to take gas away from the delivery point). This case would seem to suggest that the confirmation by the LDC takes precedence over upstream primary or secondary delivery point rights.

[66] *See, e.g.*, Northwest Pipeline Company, 67 FERC ¶ 61,095 (1994) (mainline constraints allocated according to path rights rather than point rights). As this case illustrates, even on web or displacement systems, capacity path rights may be defined.

[67] See text accompanying note 64, *supra*.

while still fairly allocating capacity among shippers.

C. Capacity Auctions

Auctions are often used as effective methods of selling goods and services. A well-structured auction can assure that pipeline capacity is allocated to the party placing the greatest value on the capacity and can assure fairness in the allocation process by preventing price discrimination or favoritism by the capacity seller. An auction provides customers with equal opportunities to acquire capacity, preventing the pipeline or releasing shipper from treating different bidders differently. Auctions also have value because they provide the market with accurate information on the value of capacity.

If a market is perfectly competitive with a sufficiently large number of capacity holders, and equal access to market information, an auction would not be necessary to limit the exercise of market power, because market power would not be present. But, even in that case, an auction may help reduce the transaction costs of trading capacity. Any attempt to charge more than a competitive price would result in the potential buyer looking elsewhere for capacity.

The current regulations seek to protect against pipeline exercise of market power by requiring pipelines to sell capacity when they have received an offer at the maximum tariff rate. This requirement prevents the pipelines from withholding capacity at the maximum rate in order to raise prices. The current regulations, however, do not require pipelines to sell capacity at a discounted rate. Thus, pipelines may be able to exercise market power at rates below the maximum rate because the pipeline is not obligated to sell capacity (can withhold capacity) at less than the maximum rate.

In markets where market power is present, an auction that limits capacity withholding can be an effective method of limiting the exercise of market power and creating a more efficient market. In today's market, during peak periods, the price cap may restrict shippers' ability to obtain capacity from the pipelines or may result in shippers paying a higher price than necessary for delivered gas either because releasing shippers exercise market power or because the market simply is not transparent enough for potential buyers to be able to locate and negotiate with alternative capacity sources. During off-peak periods, shippers similarly may have to pay more than necessary to obtain capacity if pipelines or releasing shippers can withhold capacity or price discriminate. Placing all available capacity in an auction would help ensure that shippers will pay lower prices both during peak and off-peak periods, because the auction process helps to ensure that prices reflect competitive market forces rather than resulting from the exercise of market power or shippers' inability to obtain accurate market information.

1. Proposed Auction Requirement

To help prevent the exercise of market power, the Commission is proposing, in revised § 284.10(c)(5), to require all available short-term pipeline firm and interruptible capacity and released capacity to be allocated through an auction process. The proposed auction requirement applies to all sales of short-term pipeline capacity, both interruptible and firm, and released capacity. Thus, all capacity sold for a term of less than a year (or whatever other time period is chosen to define short-term capacity) would be sold through an auction process. Using an auction process for all capacity, during both peak and off-peak periods, is necessary to limit the exercise of market power and to allow the market to determine the value of capacity.

The Commission is proposing that pipelines adhere to the following principles in designing an auction:

- all available short-term capacity must be sold through an auction;
- daily capacity from the pipeline must be allocated based on the auction without the establishment of a reserve or minimum bid price;
- all eligible shippers must be permitted to bid with no favoritism shown to pipeline affiliates or other shippers;
- the procedures and rules for each auction, including the auction schedule, must be disclosed in the pipeline's tariff in advance of the auction and must be applied in each auction;
- capacity must be allocated based on established criteria and parameters known in advance to all bidders and the same criteria and parameters must apply to pipeline and released capacity;[68] and
- shippers must be able to validate that the auction was run properly either through the posting of information sufficient to permit them to validate that the winners were selected appropriately or through the use of other mechanisms, such as an independent third-party, which will validate the results.

The requirement of an auction for short-term capacity still leaves the question of whether to retain the current bidding procedure for long-term capacity release transactions.[69] Pipelines are not subject to any auction or bidding requirements in selling long-term capacity. To ensure comparability, the Commission, therefore, proposes to permit shippers to release capacity on a long-term basis without going through a bidding process. As is the case for the pipelines, no sales of long-term capacity can exceed the pipeline's maximum rate.

The proposal for auctions of capacity raises issues about auction design that will be discussed below. The first issue is whether to permit pipelines or releasing shippers to establish a reserve or minimum price below which they are not obligated to sell capacity. The second is how to design the auction to work most efficiently.

2. Reserve Prices

The Commission is proposing two different auction methodologies for pipeline capacity. For capacity sold for one day, the Commission is proposing a daily auction in which pipelines cannot establish a reserve price. Pipelines would not be required to sell below the minimum rate (variable cost) in their tariffs. For auctions of longer than one day, pipelines would be permitted to establish reserve prices.

Prohibiting pipelines from establishing a reserve price would limit their ability to withhold capacity. Requiring pipelines to auction their daily capacity, without a reserve price, should be sufficient to prevent them from withholding capacity for longer short-term transactions, for instance, a deal for three months' worth of capacity. The pipeline should not be able to demand a monopoly price for three months' worth of capacity because shippers would not pay that price. A shipper would pay only the amount that it would expect to have to pay if it purchased the capacity in the daily auction plus a premium for the insurance value of locking-in the capacity and price for a set period of time.

For capacity available for periods of longer than one day, pipelines could establish reserve prices. Pipelines may have a legitimate basis for believing that the market value for their capacity on a single day is less than what the capacity will be worth at a later date or if the capacity ultimately was sold on a longer-term basis.

The auctions of pipeline capacity would work in the following manner. When a pipeline has firm capacity

[68] *See* 18 CFR 284.10(b)(1)(v), Capacity Release Related Standards 5.3.3 and 7.3.14 (three methods for valuing bids, highest rate, net revenue, and net present value).

[69] *See* CFR 284.243(e).

available for more than one day, for instance six months beginning on July 1, the pipeline could establish a reserve price for the six month block of capacity. If that capacity was not sold by June 30, the pipeline would have to sell the capacity for July 1 through the auction process for that day. The pipeline, however, could continue the reserve price for shippers willing to bid on the six month (less one day) block of capacity. This process would continue until the capacity is sold.

The daily auction also would apply to available pipeline storage capacity. But comments should address whether a daily auction for storage capacity is practical, whether different rules should apply to storage capacity, and whether storage capacity needs to be included in the daily auction to prevent capacity withholding.

The Commission is proposing that all short-term releases of capacity by firm shippers take place through the auction to ensure that capacity is allocated on a non-discriminatory basis to the purchaser placing the greatest value on the capacity. Releasing shippers would be permitted to place reserve prices on their capacity, because they have a legitimate basis for retaining capacity for their own use. For instance, firm shippers may need to reserve capacity to meet unanticipated weather changes, to replace depleted storage, or to change to a substitute supply to ensure reliable service. Moreover, firm capacity holders should not be able to withhold capacity because, under the proposal, if a firm capacity holder does not nominate (use) its capacity, the pipeline would be required to sell the unnominated capacity as interruptible or short-term firm capacity through the auction.

The Commission, however, requests comment on a number of aspects of its proposed approach to reserve prices. Commenters should address whether requiring pipelines to sell capacity at the bid price for only one day is sufficient to limit the pipeline's ability to withhold capacity. Commenters should address the question of the price at which capacity should be sold. For example, should all shippers pay the market-clearing price (lowest price necessary to get capacity)[70] or should each shipper pay the price it bids?

Commenters also should address whether the proposed requirement to sell pipeline daily capacity without a reserve price could cause cost-recovery problems for some pipelines. If shippers on a pipeline where capacity is not sufficiently constrained relied exclusively on the daily auction, the revenue received may be insufficient to cover the pipeline's costs allocated to interruptible and short-term firm capacity.[71] The daily auction without a reserve price also may affect the ability of pipelines to resubscribe firm capacity at maximum rates as contracts expire, which could cause cost recovery problems. If the pipeline is expected to be uncongested, shippers may prefer to rely on the daily auction rather than resubscribing to firm capacity.

On the other hand, it may be that most pipelines are sufficiently constrained so that the daily auction requirement will not limit their ability to recover their costs.[72] The proposal to limit the requirement to sell capacity without a reserve price to one day may itself reduce the risk to pipeline cost recovery. Some shippers may be unwilling to take the risk of not having firm capacity.

In addition, on some pipelines, the requirement for a daily auction may give large customers greater leverage over pipelines in negotiating renewal contracts. When a large customer's firm contract expires, it may well decide not to renew that contract and to submit low bids for capacity in the daily auction. If the purchaser is the principal, if not the only, shipper for a large block of pipeline capacity, it could be reasonably confident that it would not be outbid by other shippers.

There are potential approaches to address these kinds of cost recovery problems if they materialize, without rejecting the benefits of an auction process. One set of possibilities is for pipelines to charge a fixed access charge to all customers using its system to recover fixed costs or a volumetric usage charge designed to recover the fixed costs of the system. These are similar to methods that are being considered in connection with congestion pricing in the electric industry.[73]

Another alternative is to allow the pipeline to set a reserve price in the daily auction that is above variable costs, but below the current maximum rate. In effect, this would be a minimum price floor below which the pipeline would not have to sell. The price floor could be established by using the dollar amounts associated with specified cost-of-service elements, such as rate of return, or could be established at a percentage of the maximum rate. This approach would still provide shippers with protection against the exercise of market power and would prevent the pipeline from discriminating in the prices it charges to specific customers while permitting the pipeline a reasonable opportunity to recover its fixed costs. However, preventing the pipelines from price discriminating may still result in cost recovery problems.

Another approach would be to limit the auction only to transactions above the maximum rate (as converted to a daily rate). The current regulations require a pipeline to sell capacity at the maximum rate to all shippers, thus preventing the pipeline from withholding capacity at the maximum rate to derive a higher price. A requirement that pipelines must auction capacity at the market clearing price, whenever such prices exceed the maximum rate, would continue the protection in the current regulations. It would protect against the pipelines' withholding capacity to raise price and would prevent them from price discriminating between shippers, because all shippers would pay the market clearing price. It also would help to ensure that the pipelines' opportunity to recover their cost-of-service is not impaired. However, such an approach would not help to constrain the pipelines' ability to exercise market power at prices below the existing cap.

Commenters should address the merits of the potential methods for dealing with situations in which the requirement to sell capacity without a reserve price would result in cost recovery problems for pipelines. Commenters also should address whether solutions should be determined on a pipeline by pipeline basis or whether there needs to be a uniform approach applicable to all pipelines.

3. Auction Design

The Commission recognizes the need for the auction to work quickly and efficiently.[74] Shippers buying capacity

[70] The market clearing price is the price at which all available capacity is sold and no shipper bidding that price or higher would be denied capacity.

[71] Pipelines are generally considered to be natural monopolies because they have very large fixed costs, with significant economies of scale. Thus, it is less expensive to have one pipeline provide service than to have two or more pipelines compete over the same route. However, when a natural monopolist is at the efficient size, where the cost of producing one additional unit (marginal cost) equals the price that a customer is willing to pay (demand), that price is not sufficient to cover the average costs of the firm. *See* R. Posner, Economic Analysis of the Law, 251–264 (2d ed. 1977).

[72] Many pipelines, however, may be at less than efficient size and, therefore, be sufficiently congested that they will be able to recover their costs.

[73] These options are discussed in the NOI on long-term services which is being issued contemporaneously with this NOPR.

[74] Shippers have complained that the Commission's current bidding process for capacity release is too cumbersome and slow. *See* Secondary

Continued

not only want the ability to consummate deals quickly, they also want the assurance they can acquire capacity in sufficient time to finalize their gas supply arrangements. The current system, which takes four hours, and must be completed the day prior to nominations,[75] is inadequate to meet the needs of the market.

An electronic auction, designed properly, can be efficient and can operate faster than the current process of sending facsimiles and using telephones to arrange deals. Electronic auctions used for trading stocks and other commodities demonstrate this efficiency.

There are a variety of auction formats that would meet the Commission's criteria as well as provide the speed the market requires. The Commission ultimately would decide on the proper auction format. It could do so either through this rulemaking, through a subsequent proceeding, or by reviewing proposals on a pipeline-by-pipeline basis, and it requests comment on which approach would be preferable. To assist the Commission in evaluating potential auction formats, comments should focus on the details of how the auction or multiple auctions should be conducted and on whether a uniform auction format should be applied to all pipelines.

For example, different auction formats could be used for intra-day, daily, monthly, and longer auctions.[76] Auctions for capacity of one day or less could be held as part of each intra-day nomination opportunity or could be held continuously, every hour during the business day. Consideration also should be given to establishing standardized parameters for recall or other conditions in order to facilitate trading for daily or intra-day capacity. To further expedite the daily auction, it could be integrated with the nomination process using a computerized auction process.

To accomplish such integration, releasing shippers could submit nominations establishing the minimum or reserve price or prices at which they would be willing to sell some or all of their capacity. For capacity the shipper wanted to use, it could establish a very high reserve price while for capacity it clearly wanted to release it could establish a zero reserve price. Bidders would submit nominations with the price they are willing to pay. Pipelines would be required to offer the released capacity along with their own available capacity. The pipeline would then apply Commission-approved procedures to determine a market clearing price and all bidders submitting bids above this price would be automatically scheduled.

Auctions for periods longer than a day could use a different format, while auctions of monthly capacity could employ posting and bidding periods that would coincide with the industry's monthly gas purchasing cycle. Longer posting and bidding times might be needed for auctions of greater than one month.

The Commission also requests comment on whether alternatives to the comprehensive auction described above would be sufficient to protect against the exercise of market power. One possibility would be only to require pipelines to sell available interruptible capacity to the highest bidder. While such an approach would not cover capacity releases or sales of pipeline firm capacity, it may be sufficient to ensure that capacity is not withheld from the market to raise price. For instance, it would protect against the incentives present in a duopoly or oligopolistic market in which firm shippers and the pipeline recognize a mutual interest in withholding capacity. If the releasing shipper tried to withhold capacity by not releasing it, the pipeline, under this option, would be forced to sell the resulting interruptible capacity to the highest bidder. Pipelines already are generally required to allocate interruptible capacity based on price when they are unable to satisfy all nominations for interruptible service at the maximum rate.[77] While this proposal would expand the requirement to all transactions, it could be implemented using the same process.

The information the Commission is proposing to require pipelines to provide is intended to enable the market to effectively monitor transactions. Indeed, the knowledge that information will be provided to the market should itself act as a check against anticompetitive transactions.

D. Information Reporting and Remedies for the Exercise of Market Power

1. Reporting Requirements

In creating a competitive marketplace, information plays a crucial role. Equal access to relevant information is necessary for shippers to make informed decisions about capacity purchases and for markets to perform efficiently. Market information also is needed so that the Commission and shippers can monitor transactions to determine if market power is being exercised.

The information needed by the market, both for decision-making and monitoring purposes, falls into three general categories: information on capacity availability, information on the structure of the market, and information on capacity transactions, such as rates, contract duration, and contract terms. Information on the amount of capacity available at receipt and delivery points and on mainline segments as well as on the daily amount of capacity that pipelines schedule at these points will help shippers structure gas transactions and cast light on whether shippers or the pipeline may be withholding capacity. To assess market structure, shippers and the Commission need to know who holds or controls capacity on each portion of the pipeline system so they can determine the number of potential sources of capacity. Transactional information provides price transparency so shippers can make informed purchasing decisions as well as permitting both shippers and the Commission to monitor actual transactions for evidence of the possible exercise of market power.

The current regulations already require the posting of much of the needed information. The proposals here would require expansion of these current reporting requirements, but such expansion appears justified to give shippers the information they need both for competitive and monitoring purposes. Moreover, in some cases, the proposals are designed to ensure that the same information is provided for competing types of capacity. For instance, detailed information on capacity release transactions, including the releasing and replacement shipper names, the rate paid, and points covered by the release are already being posted at the time of the transaction.[78] In contrast, pipelines are only required to file limited information on their discount transactions well after the transaction has taken place.[79]

Market NOPR, IV FERC Stats. & Regs. Proposed Regulations at 33,244.

[75] 18 CFR 284.10(b)(1)(v) (1997), Capacity Release Related Standards 5.3.2.

[76] The Commission's current regulations, for instance, provide for longer posting and bidding periods for transactions of five months or longer than for shorter-term transactions. 18 CFR 284.10(b)(1)(v), Capacity Release Related Standards 5.3.2.

[77] *See* Sea Robin Pipeline Company, 81 FERC ¶ 61,041, at 61,225 (1997); Pacific Gas Transmission Company, 76 FERC ¶61,258 (1996).

[78] 18 CFR 284.10(b) (1)(v), Capacity Release Related Standards 5.4.1, 5.4.3.

[79] 18 CFR 284.7(c) (6).

a. Information on Available Capacity. For capacity availability, the current regulations require posting of information about the amount of operationally available capacity at points and on the mainline.[80] But, in order to effectively determine whether capacity is being withheld, information also is needed to show the total design capacity of the point or segment and the amount scheduled on a daily basis. The Commission proposes in proposed section 284.14(d) to add this information to the posting requirements.

The Commission also proposes, in proposed § 284.14(d) to require pipelines to post information on planned and actual maintenance or system outages that would reduce the amount of capacity available. While some pipelines currently post such information, it is not currently a Commission requirement. Shippers can better make decisions about their use of capacity if they know whether the available capacity will be reduced on a particular day. Such information will also help in monitoring capacity withholding by revealing reasons for reductions in scheduled quantities.

b. Information on Market Structure. With respect to the structure of the marketplace, pipelines currently file with the Commission, and post on their Internet web sites, an Index of Customers, which (under § 284.106(c)(3) of the regulations, new § 284.14(b)) provides information on the names of shippers holding firm capacity, the amount of capacity they hold, and the duration of their contracts. But the Index of Customers does not provide information on the capacity path held by the shipper, so the data cannot be used to determine which shippers can compete in providing capacity on segments of the pipeline. The Commission, therefore, proposes to add a requirement, in proposed section 284.14(b), to include in the Index of Customers the receipt and delivery points held under the contract, the zones or segments in which the capacity is held, and the shipper's contract number. The contract number is needed on the Index of Customers as well as on the report of capacity release transactions so capacity can be traced through release transactions to reveal how much total capacity each shipper holds. Since the current capacity release requirements do not include the contract number, the Commission is proposing to require that the number be provided.

In addition, to permit effective monitoring of the capacity held on pipelines, it is necessary to know affiliate relationships, which may affect the amount of capacity held by a single parent entity. The Commission, therefore, proposes to add a requirement in proposed section 284.14(b) that pipelines disclose in the Index of Customers any affiliate relationship between the pipeline and the holder of capacity and any affiliate relationship between holders of capacity. Additionally, the Commission would require disclosure of affiliate transactions in capacity release transactions.[81]

The Commission also is proposing to expand its affiliate regulations to provide more information to permit monitoring and self-policing of affiliate transactions. The Commission is proposing to add a new section 161.3(i) and revise section 284.286(c) to require pipelines to post on their web sites organizational charts, and job descriptions, including the names of senior employees,[82] for the pipeline, its marketing affiliates, and gas sales operating units.[83] The pipeline would not be required to include employees whose duties are purely clerical or those who do not have access to information concerning the processing or administration of requests for service (such as employees who operate or repair the pipeline facilities). The Commission also is proposing to include in the Internet posting the list of the operating personnel and facilities shared by the interstate pipeline and its marketing affiliate or gas sales operating unit. The pipelines currently provide this information in their tariffs, under § 250.16(b)(1), and this requirement will make all affiliate information easily available on the Internet. The Commission has adopted a similar requirement in the electric industry to help monitor, and protect against, improper communications between transmission and wholesale merchant function employees.[84]/

In addition, in the current market, shippers may be using agents or asset managers to manage their capacity and such managers may be given wide latitude over the way in which capacity is used. The Commission, therefore, is proposing to add a requirement in § 284.14(b) that pipelines disclose such agents or asset managers when they control 20% or more of capacity in a pipeline rate zone, as well as the rights of the agent or asset manager with respect to managing the transportation service. This information would help to show the degree of control over pipeline capacity that an agent or asset manager may exercise.

c. Transactional Information. Pipelines already provide transactional information for their own capacity transactions and for capacity release transactions, although the type of information and the manner of accessing it differ. For capacity release transactions, pipelines provide via the Internet the names of the releasing and acquiring shippers, the price, the receipt and delivery points under the deal, the quantity of capacity traded, and the duration of the deal.[85] This information is posted immediately upon consummation of the transaction. The information provided about pipeline transactions is not as complete, nor is it as timely or as easy to access. Pipeline discount reports are filed, but not posted, 15 days after the close of the billing period applicable to the transaction and include only the rate paid and the maximum rate, but do not include any information on volumes, the receipt and delivery points under the transaction, or the duration of the deal.[86]

To assure parity of transactional information, the Commission proposes, as described, to require the pipelines to provide the same information about their transactions as is currently provided about capacity release transactions. The Commission recognizes that some pipelines and shippers have previously expressed concern about posting information on shipper names to preserve

[80] 18 CFR 284.8(b) (3); 18 CFR 284.10(b) (1) (iv) (1997), Electronic Delivery Mechanism Related Standards 4.3.6; 18 CFR 284.10(b) (1) (v), Capacity Release Related Standards 5.4.13.

[81] Some pipelines now require disclosure of affiliate transactions for capacity release transactions. 18 CFR 284.10(b) (1) (v), Capacity Release Related Standards 5.4.3. This requirement would become mandatory for all pipelines under this proposal.

[82] Senior employee would be defined as an employee who supervises non-clerical employees engaged in transmission/reliability or gas marketing functions.

[83] Contemporaneously with this NOPR, the Commission is issuing a final rule adding a requirement to 18 CFR 161.3 requiring pipelines to post the names and addresses of their marketing affiliates on their web sites. Reporting Interstate Natural Gas Pipleline Marketing Affiliates on the Internet, Docket No. RM98–7–000. For the NOPR, see Reporting Interstate Natural Gas Pipeline Marketing Affiliates on the Internet, Notice of Proposed Rulemaing, 63 FR 27526 (May 19, 1998), IV FERC Stats. & Regs. Proposed Regulations ¶ 32,530 (May 13, 1998). Should the Commission adopt the regulations proposed in this NOPR, the changes could be consolidated with the requirement for posting affiliate names and addresses.

[84] American Electric Power Service Corporation, 83 FERC ¶ 61,357 (1998).

[85] 18 CFR 284.10(b)(1)(v), Capacity Release Related Standards 5.4.1, 5.4.3.

[86] 18 CFR 284.7(c)(6).

confidentiality. However, shipper names currently are posted for capacity release transactions and the Commission is unable to see how other shippers can effectively monitor transactions for favoritism if names are not provided.

In many cases, much of the transactional information would be provided in a properly designed, transparent short-term capacity auction. To ensure that the information is provided, the Commission is proposing to add a new section, 284.14(c), that would require pipelines to post on their Internet web site, and provide downloadable files of, transactional information about their own capacity transactions and released capacity transactions. For firm service, the Commission proposes that the pipelines provide contemporaneously with the execution of the contract, the same information already posted for capacity release transactions: the parties to the contract; the contract number for the shipper receiving service and for the releasing shipper; the rate charged under each contract; the duration of the contract; the receipt and delivery points and mainline segments covered by the contract; the contract quantity; any special terms and conditions applicable to the contract; and any affiliate relationship between the pipeline and the shipper or between the releasing and replacement shipper. For interruptible transportation, the following information on a daily basis would be required: the name of the shipper; the rate charged; the receipt and delivery points and mainline segments over which the shipper is entitled to nominate gas; the quantity of gas the shipper is entitled to nominate; and any affiliate relationship between the shipper and the pipeline.

2. Remedies if the Exercise of Market Power Is Found

While the Commission's proposals should enhance efficient competition and mitigate market power, the Commission is committed to take remedial action when pipelines or shippers exercise market power. Because the facts of each such case would be different, it is difficult to describe in advance the type of remedy the Commission would impose if market power is being exercised, and not all remedies would be appropriate in every case. As a general matter, the Commission's preference would be to use a structural remedy that would enhance efficient competition. Examples of such remedies would include revising contractual provisions that inhibit competition, strengthening the capacity auction requirement, requiring pipelines to build taps to increase access to capacity, or conducting auctions to determine whether sufficient demand exists for additional construction. Another potential remedy would be to use a benchmark for regulating price increases based on price changes in comparable competitive markets.[87] Reimposition of some form of price cap also would be a possible option if other available remedies are not adequate. Commenters should address the potential remedies suggested here as well as suggest other possible remedies.

IV. Penalties and Operational Flow Orders

A major goal of the changes proposed in this NOPR is to improve competition in the short-term market both to improve the efficiency of the market and to protect against the potential exercise of market power. To improve efficiency and competition across the pipeline grid, the Commission previously has adopted standards, promulgated by GISB, as well as the Commission's own standards governing business practices and electronic communication. But these standards have only partially addressed the effect that pipeline operational flow orders, tolerances, and penalties have on competition across the pipeline grid.

Penalties and operational flow orders (OFOs) are necessary tools to deter shipper behavior that threaten the integrity of the pipeline system. At the same time, they have a significant effect on efficiency and competition by restricting shippers' abilities to effectively use their transportation capacity. As just one example of the interrelation between penalties and the short-term market, penalty levels can affect the value of capacity in the short-term market; shippers needing gas might be willing to buy transportation capacity at any rate less than the penalty they would have to pay if, for instance, they overran their contract entitlement. In this section, the Commission considers reforms to its policies for regulating OFOs and transportation penalties to ensure that they can continue in their legitimate role of protecting pipeline integrity, while not unnecessarily limiting or restricting competition in the marketplace.

These policies have their origin in the regulatory reforms instituted by the Commission in Order No. 636. To promote competition in the sales and transportation markets, Order No. 636 required that pipelines unbundle sales and transportation services. The bundled sales service provided considerable flexibility for the pipeline in how it would meet the requirements of its customers, particularly on peak days. In the implementation of Order No. 636, the Commission was particularly concerned that the unbundled transportation services be as reliable as the bundled sales service the pipelines previously provided.

To address that concern, the Commission accorded each pipeline considerable discretion and authority to operate its system to ensure its reliability, particularly during peak and emergency times. One important tool the Commission has sanctioned is the use by pipelines of OFOs that can restrict service or require shippers to take particular actions. As examples, Commission-sanctioned OFOs can: reduce or eliminate tolerances for imbalances or contract overruns; institute severe penalties; restrict intra-day nominations; restrict or eliminate the use of secondary receipt and delivery points; and restrict firm storage withdrawals and eliminate interruptible storage withdrawals.

Another means the Commission has provided pipelines to protect system reliability is the approval of tariff penalties designed to deter shippers from creating imbalances or from overrunning contract entitlements. The Commission has approved particularly high penalties, with little or no tolerance for imbalances or overruns, applicable during peak or emergency periods to protect pipeline reliability. The Commission also has approved penalties, usually at lower dollar levels and greater tolerances, applicable during non-peak times to help ensure that shipper imbalances or overruns do not create emergency conditions on a pipeline that could have been prevented or minimized.

The Commission believes that a review of present policies and pipeline practices in these areas is appropriate as part of the new approach to pipeline regulation proposed in this NOPR— and particularly its objective of promoting competition in the short-term market.

On initial review, it appears that some pipeline practices and Commission policies regarding penalties can inhibit competition not only with respect to transportation, but also in the sale of natural gas. For example, an OFO that eliminates a secondary receipt point for a shipper may eliminate the shipper's access to alternate suppliers with the lowest priced gas or force the shipper to

[87] *See* Buckeye Pipe Line Company, 53 FERC ¶ 61,473, at 62,683 (1991) (basing price changes in non-competitive markets on the changes in competitive markets).

points where it has no purchase or sales agreements. An OFO that limits or eliminates a shipper's storage withdrawals may require the shipper to purchase more costly gas on the spot market if the OFO allows the shipper to shift to new points. The longer OFOs are in effect, the more restrictive they become. Across all customers, OFOs may fragment markets by making it impossible for many potential sales of gas or transportation services to take place.

High penalties on contract overruns or imbalances as well as low or no tolerances during peak periods may also operate to limit and distort market forces. For example, not all shippers have immediate access to metering information on their imbalances or even the volumes of gas they receive at their delivery points. This lack of information may adversely affect shippers in several ways. For example, to avoid overrun and/or imbalance penalties, shippers may not maximize use of pipeline transportation, and shippers may contract for more transportation capacity than they need. Also, the lack of information on imbalances and delivered volumes may inhibit shippers from trading imbalances or transportation capacity that could alleviate or prevent system operational problems.

The presence of severe penalties/tolerances during peak or emergency periods also may preclude other uses of market forces that could alleviate or prevent system operational problems. For example, a shipper that delivers more gas than nominated into a pipeline when the pipeline is short of gas would help to maintain system integrity. Yet, under most currently approved tariff provisions, the shipper could be penalized for doing so.

Moreover, Commission-authorized penalties may provide an opportunity for shippers to engage in a form of penalty arbitrage. For example, during the 1995–96 winter there was a shortage of natural gas to serve Chicago markets. Shippers reacted by intentionally overrunning contract entitlements on those pipelines and LDCs that had the lowest penalties for contract overruns. [88] In that situation, penalties appeared to have skewed choices shippers might otherwise have made. The consequence was that pipelines in the Chicago area appear to have entered into bidding wars for the highest overrun/imbalance penalties, with penalties for large variances running as high as $200/dth.[89]

The fluctuation of transportation values also supports a reexamination of Commission policies on OFOs and penalties. As discussed earlier, the value of transportation varies widely. For example, as shown on the earlier graph, during the winter of 1996–1997, the value of capacity was double the maximum rate, while during the winter of 1995–1996, spikes occurred on several occasions to much higher levels, with the highest value reaching $10/MMBtu.[90]

The fluctuation in short-term transportation values during peak periods suggests the need to increase opportunities, as much as practicable, for shippers to obtain transportation services at the lowest competitive price during such times. Yet, the pipelines' current OFO and penalty structures may restrict shippers' options more than is necessary.

Current pipeline tariff provisions for remedying monthly imbalances of a shipper—often described as ''cash-outs''— also appear to inhibit market forces and may be otherwise unfair. Under these provisions, shippers are allowed to cash-out net monthly imbalances using an average monthly price. That procedure invites shippers to game the system within the month. For example, a shipper may take more than it delivers when gas prices are high and deliver more than it takes when gas prices are low. At peak, such behavior may imperil system-wide reliability and unnecessarily trigger OFOs and emergency penalties that restrict or eliminate market forces. Such gaming also promotes inefficient use of pipeline capacity. For example, to the extent gaming is substantial on a pipeline, the pipeline is likely to react by imposing stricter imbalance tolerances and higher penalties. Moreover, gaming by some shippers is subsidized by other shippers. A pipeline's tolerance and penalty levels are often a function of the amount of storage it has retained; a pipeline with more storage can tolerate greater imbalances. But all shippers pay for storage in their firm rates. Accordingly, if a pipeline reduces tolerances and raises penalties due to the behavior of some shippers, the firm shippers lose the flexibility for which they are paying.

The apparent problems associated with current OFO and penalty tariff provisions suggest the need to reorient policy away from penalties and towards promoting the opportunities for shippers to avoid penalties and to prevent penalty situations, particularly by allowing shippers to avail themselves of remedies that the marketplace can provide. Such remedies would include the trading of imbalances, the provision of timely information about system imbalances so shippers can better anticipate adverse operational conditions and avoid possible penalties, and no harm no foul rules under which shippers will not be penalized for actions that help maintain the operational integrity of the pipeline system. Stated in other terms, while there may always be a need for penalties and OFOs, the adoption of policies that promote the opportunity for shippers to avoid penalties and prevent penalty situations, particularly by reliance on market forces, may be the most efficient means of ensuring the reliability of a pipeline's system operations. Towards this end, the Commission, in Order No. 587-G, recently required pipelines to permit shippers to offset imbalances across their own contracts and to trade imbalances with other shippers.[91]

Accordingly, the Commission proposes to revise section 284.13 of its regulations to establish the following policies. First, the Commission proposes to require each pipeline to provide, on a timely basis, as much information as possible about the imbalance and overrun status of each shipper and the imbalance of its system as a whole. The adoption of this policy is a critical first step to enhancing the opportunities of a shipper to avoid penalties and help prevent penalty situations. Second, to ensure greater shipper flexibility, the Commission proposes to require that pipelines have in place only those transportation penalties that are necessary and appropriate to protect system operations. Third, the Commission proposes to require that pipelines provide services, to the extent operationally feasible, that facilitate a shipper's ability to manage imbalances, which will also help the shipper avoid penalties and prevent penalty situations. Finally, the Commission proposes to require pipelines to adopt incentives and procedures that will minimize the use and potential negative impact of OFOs.

As discussed below, the Commission solicits comments on these proposed policies. The Commission also invites

[88] *See* Industry Surveys the Damage as Winter's Strength Runs Out, Natural Gas Intelligence, April 22, 1996, at 1; Freezer Burn, Gas Daily's NG, April 1996, at 30.

[89] *See* Panhandle Eastern Pipeline Company, 78 FERC ¶ 61,202, at 61,876 (1997)(penalties ranging from $25 per Dth for variances of 5–10% to $200 for variances over 50%).

[90] *See* text accompanying note 22, *infra.*

[91] Standards For Business Practices Of Interstate Natural Gas Pipelines, Order No. 587-G, 63 FR 20072 (Apr. 23, 1998), III FERC Stats. & Regs. Regulations Preambles ¶ 31,062 (Apr. 16, 1998).

comments on its assessment, set forth above, of current OFO and penalty tariff provisions on which the proposed policies are based. Specifically, the Commission solicits comments on how well these current tariff provisions protect the integrity of system operations, the extent to which such provisions have created the problems discussed above, and whether changes to such tariff provisions are warranted.

A. Pipelines Should Provide, on a Timely Basis, as Much Imbalance and Overrun Information as Possible

The Commission proposes to require each pipeline to provide, on a timely basis, as much information as possible about the imbalance and overrun status of each shipper and the imbalance of its system as a whole. Providing such information is a critical first step to a new Commission approach to penalties. To begin with, such information, by itself, would help shippers avoid overruns and imbalances. Moreover, providing each shipper with information on the precise level of its deliveries and imbalances would help the shipper maximize the use of its transportation rights on the pipeline system. Such information could also allow the pipelines to reduce the level of penalty-free tolerances and so reduce system costs (e.g., storage capacity to provide such tolerances). Finally, such information together with information on system imbalances would facilitate trading of imbalances and capacity or other self-help measures that in turn could alleviate or prevent conditions that imperil system integrity.

Under the proposed regulation, § 284.13(c)(2)(iv), the pipeline would not be required to install real time meters. The burden on the pipeline would be limited to distributing on a timely basis—i.e., so that the shipper has a reasonable opportunity to avoid penalties—the information the pipeline currently has on deliveries and imbalances at each shipper's delivery point as well as system imbalances. The pipeline would be required to establish a system that notifies each shipper individually of the imbalance/delivery information that the pipeline possesses or to give shippers access to such information via the Internet. The pipeline could post relevant system imbalance information more generally. The obligation that such information be provided on a timely basis would vary from pipeline to pipeline, depending on the pipeline's penalties. For example, a pipeline that imposes imbalance penalties only on a monthly basis would have a different obligation to provide imbalance information to its shippers than a pipeline that imposes daily imbalance penalties.

During technical conferences in individual cases, relating to proposals by pipelines to institute or increase penalties, many pipelines have provided assurances that they were moving toward better metering on their system. On the other hand, customers have complained of the imposition of penalties because existing metering equipment was insufficient to provide them with timely information on deliveries and imbalances. An important question raised by the proposed policy is the manner in which, if at all, the Commission should address the situation in which a shipper has receipt or delivery points at which there is not the type of metering and related equipment that would provide the shipper with timely information on its deliveries and imbalances. The Commission sets forth below two options and solicits comment on them.

One option, which would be a departure from the proposed policy set forth above, is to require the pipeline to install the equipment that would provide all shippers with timely information on imbalances and deliveries. Important questions that should be addressed when considering this option are, first, the extent to which such equipment is not in place today and, second, the extent to which the shippers without such equipment desire the information that would be provided. For example, the Commission is aware that marketers and producers have voiced complaints about the lack of timely information on deliveries and imbalances. Those complaints suggest that there may be more of a problem in obtaining timely information at receipt points than at delivery points.

A closely related and critical question is the cost of purchasing and installing the equipment that will provide timely information. Those costs must be compared in some manner to the benefits of providing the equipment. The question of costs raises a host of other related questions. For example, who should pay for the equipment—the pipeline (who could recover the costs in generally applicable rates) or the shipper? Is it appropriate to require all shippers to have access to such information? For example, it may be cost effective only for large shippers. Should the Commission require the metering needed to provide timely information only at those receipt/delivery points where the gas volumes are large enough to cover the equipment costs, and exempt the remaining receipt/delivery points? If so, what alternatives are appropriate for receipt/delivery points of small shippers to provide some parity of treatment?

A second option would be to forbid a pipeline from imposing a penalty for an overrun/imbalance that does not threaten system reliability unless the pipeline has metering equipment to measure the imbalance/overrun and notifies the shipper in a timely manner of the imbalance/overrun. The intent of this option is to give a pipeline an incentive to install only the metering equipment associated with imbalances or overruns that may imperil system integrity. The option also would prevent penalties that a shipper would have been in a better position to avoid with timely information.

This option also raises the question of who should bear the costs of the enhanced metering and related facilities. Another relevant concern is the extent to which the option could be implemented—is there an objective basis to determine which penalties are required, and in what situations, to prevent realistic threats to a pipeline's system integrity?

The Commission solicits comments on its proposal, the alternative options, and the related questions. The Commission also solicits other alternative proposals that commenters believe merit consideration.

B. Transportation Penalties Must Be Necessary and Appropriate to Protect System Operations

The Commission proposes to require that pipelines have in place only those transportation penalties that are necessary and appropriate to protect system operations. The Commission has authorized extremely high overrun and imbalance penalties for several pipelines on the basis that doing so was required to protect system integrity.[92] The Commission questions whether there is necessarily a connection between the high level of penalties that have been authorized and the level that is necessary to ensure system reliability. Also, the Commission is aware that some pipelines have penalties that are at the same level during peak and non-peak periods and may be imposed regardless of whether the pipeline is faced with emergency conditions.[93] In light of these considerations, the Commission solicits comments on

[92] *See* Northern Natural Gas Company, 77 FERC ¶ 61,282, at 62,236 (1997); Panhandle Eastern Pipeline Company, 78 FERC ¶ 61,202, at 61,876–77 (1997), *reh'g denied*, 82 FERC ¶ 61,163 (1998).

[93] *See* Tennessee Gas Pipeline Company, 81 FERC ¶ 61,266, at 62,312; *reh'g denied*, 83 FERC ¶ 61,063, at 61,335 (1998) (contrasting a penalty based on spot pricing which varies penalty levels in response to market conditions with other pipelines with fixed penalty levels).

whether currently effective penalties are the most appropriate and effective penalties to protect system operations. The Commission also solicits comments on the specific criteria the Commission should rely on in determining what penalty provisions would be the most appropriate and effective.

There are many specific options the Commission may pursue in this area on which comments are requested. One option would be to require, on an industry-wide basis, penalties that are not set at specific dollar levels, but instead reflect the varying gas commodity prices that are available to the shipper—for example, a regional index plus an adder. The use of such indices could allow a more effective deterrence based on current market conditions. For example, a penalty based on commodity prices might eliminate a recurrence of the situation during the 1995–96 winter in the Chicago market where shippers sought to overrun contract entitlements on the pipeline system with the lowest stated dollar penalty.

A related option is for the Commission to establish procedures that would allow all segments of the natural gas industry to form a consensus, to the extent practicable, on penalty tariff provisions that could be uniform either on a national or regional basis. Such provisions could:

- define the particular penalties and to whom they would apply;
- implement cash-out provisions on all pipelines;
- set tolerance levels;
- determine the time periods when the penalties would be applicable;
- define the time periods to notify shippers of penalties; and
- allow make-up and/or trading of imbalances.

A prominent concern underlying this option is to eliminate the gaming where a shipper shifts capacity use among pipelines to overrun its rights on the pipeline that has the lowest level of penalties. Setting uniform standards for penalty provisions should reduce this gaming problem and the incentive for a pipeline to adopt ever more onerous penalty provisions to avoid having the least onerous penalties in an area or region.

Another objective underlying this option is to eliminate the adverse effects on competition that are caused by the fact that penalty provisions vary from pipeline to pipeline. Such variation gives rise to administrative costs and uncertainty and acts as a disincentive for shippers seeking alternative suppliers of gas and transportation services.

The Commission has successfully prompted, by adopting recommendations of GISB, the standardization of many of the operating rules of interstate pipelines to enhance competition. In that regard, the Commission stresses that the intent of this option is not to determine standardized penalty provisions as part of the rulemaking, but rather to initiate a process in which a consensus may be achieved. The Commission solicits comment on whether the industry could develop such standards through GISB or whether the Commission would need to establish its own process for developing the standards.

A variant of the last option is to establish procedures that would also include state representatives that could facilitate the coordination of (a) penalty provisions used by interstate pipelines with (b) penalty provisions that are used by state regulated entities—LDCs, Hinshaw and intrastate pipelines. The Commission believes that such coordination would better address the problem of gaming as well as enhance competition in both the sales and transportation of natural gas. State regulators are particularly invited to comment on the desirability of this option as well as to suggest procedures to implement it.

In addressing the proposals to develop a consensus process, commenters should provide their views on the practical extent to which certain types of penalty provisions can be standardized. For example, it may be impractical to adopt particular levels of penalties or tolerances on a national or even regional basis, given the different operational characteristics of each pipeline. The Commission also seeks alternative proposals to developing a consensus process that would address the goals, described above, of eliminating gaming and the administrative costs and uncertainty that arise due to the fact that penalty provisions vary from pipeline to pipeline.

Another option would be to provide an automatic credit to shippers for a significant portion of the imbalance or contract overrun penalty revenues a pipeline collects. Such a credit would not be provided to those shippers that incurred the imbalance or overrun penalty. Current Commission policy is not to provide an automatic credit, but to take such penalty revenues into account in a rate case to develop a pipeline's revenue requirement. Customers of pipelines have often complained that such an approach is inappropriate when pipelines are no longer required to file rate cases on a periodic basis. Those customers argue that to the extent the penalty revenues are not reflected in rates, penalty provisions act as a profit center for pipelines. Crediting penalty revenues would eliminate an incentive for pipelines to propose unnecessarily high levels of penalties or provisions that unduly restrict the transportation rights of a shipper.

The Commission invites comments on the extent to which there is a need to provide an automatic credit of penalty revenues. The Commission is particularly interested in comments on the extent to which penalties are, or are not, a significant source of pipeline revenues. The Commission is also concerned that the crediting of penalty revenues to specific non-offending shippers may be difficult to implement. The Commission seeks comments on whether such crediting can be implemented without substantial administrative cost. The Commission also solicits proposals for a specific mechanism for crediting penalty revenues.

Another option on which the Commission solicits comments is the desirability of revising the manner in which a shipper's cash-out payment is determined. As discussed, current cash-out procedures establish a payment based on the average price of gas for a given month, which has induced shippers in some instances to game the pipeline system to take advantage of changes in the price of natural gas. A revision that could eliminate such gaming would be to require the pipeline to provide a running imbalance of each shipper for each day of the month. The imbalance would be defined not in volumes, but in imbalance revenues, which would be the product of the shipper's volumes of imbalance that particular day times that day's gas index price. One concern this option raises is whether it would require pipelines to install additional or enhanced meters and, if so, whether the costs of doing so would outweigh the benefits of resolving the problems associated with the gaming of the system.

The Commission solicits comments on its proposal, the alternative options, and the related questions. The Commission also solicits other alternative proposals that commenters believe merit consideration.

C. Pipelines Must Provide Services, to the Extent Operationally Feasible, That Facilitate Imbalance Management

An expansion of the number of imbalance management services would reduce the need for penalties and the imposition of unnecessary penalties.

The Commission has recently taken a first step in this direction in Order No. 587–G[94] when it required pipelines, *inter alia,* to

- allow firm shippers to revise nominations during the day (thereby reducing the probability of imbalances caused by inaccurate nominations);
- enter into operational balancing agreements at all pipeline to pipeline interconnections;
- permit shippers to offset imbalances across contracts and trade imbalances amongst themselves when such imbalances have similar operational impact on the pipeline's system; and
- provide notice of OFOs and other critical notices by posting the notice on their Internet web sites, which would be accessible to shippers nationwide and by notifying the affected customers directly.

In this section the Commission proposes to require pipelines to revise their tariffs to expand the number of imbalance management services and opportunities available to shippers. Parking (temporary storage) and lending (temporary loan of gas) are currently offered by several, but not all, pipelines and allow shippers to avoid imbalances. Under the proposal, a pipeline would be required to provide such services if operationally practicable. In addition, a pipeline would be required to revise or eliminate any tariff provision that gives undue preference to its storage or balancing services over such services that are provided by a third party. In response to the tariff filing, parties could protest the proposals and propose alternatives for Commission consideration.

The Commission solicits comments on whether more specific requirements or additional initiatives would be appropriate. One prominent area of inquiry is the manner and extent to which the Commission should encourage the availability of parking and lending as well as alternative services. Some incentives are already provided for in this NOPR. For example, because parking and lending are short-term services, providers of such services would not be subject to a rate cap. The Commission could also facilitate the use of third-party storage by specifically requiring that a pipeline's transportation charges for long-term services related to injection and withdrawal of gas that comes from third party storage must be the same as the charges that apply for long-term services when the gas comes from the pipeline's own storage facilities.

The Commission could also adopt policies that promote individual shipper actions that alleviate system imbalances or operational constraints. For example, the Commission has recently established a ''no harm, no foul'' policy that would permit beneficial imbalances to escape penalties.[95] Such a policy is especially important in emergency or peak periods, when a shipper's imbalance can run in the opposite direction from the conditions adversely affecting the pipeline. A shipper with such a beneficial imbalance (one that runs in the opposite direction of the imbalance that adversely affects the pipeline system) is aiding rather than adversely affecting the system at a critical time. For example, a shipper might be taking less than it nominated on a pipeline that was suffering from significant overtakes of gas. This policy prohibits a pipeline from penalizing a shipper to the extent that such ''good'' behavior can be tracked.

A variation of a ''no harm, no foul'' policy would be to go beyond immunizing a shipper running a beneficial imbalance from penalties, and to reward such shippers especially during emergency time periods. On the other hand, in Order No. 587–G the Commission has required pipelines to permit shippers to net imbalances across contracts and trade imbalances with other shippers. In light of these requirements, would rewarding shippers running beneficial imbalances provide significant additional benefit?

The Commission solicits comments on its proposal, the alternative options, and the related questions. The Commission also solicits other alternative proposals that commenters believe merit consideration.

D. Pipelines Must Adopt Incentives and Procedures That Minimize the Use and Adverse Impact of OFOs

Finally, the Commission proposes to require each pipeline to adopt incentives and procedures that minimize the use and adverse impact of OFOs. The imposition of OFOs may severely restrict the purchase and transportation alternatives available to a customer during peak periods, precisely when such alternatives are critically needed to enhance the opportunities of a shipper to purchase such services at the lowest competitive prices. Under current practice, pipelines have incentives to favor OFOs as the first option, not the last resort. The pipeline is likely to err on the side of using an OFO, because it bears the risk that if it does not, curtailment of load may result that could in turn precipitate strong public disapproval and law suits from firm customers. In contrast, shippers—not pipelines—bear the costs that result from imposition of OFOs. A pipeline could also prefer OFOs because it would limit or eliminate a shipper's option to purchase transportation that would be in lieu of transportation services provided by that pipeline. In technical conferences, shippers have complained that OFOs have been issued too frequently, for too long, and were larger in scope than required to protect the integrity of system operations.[96]

In light of these considerations, it is appropriate to review existing pipeline tariffs to ensure that the resort to, and adverse impact of, OFOs are reduced to the maximum extent practicable. The Commission therefore proposes to require each pipeline to revise its tariff to the extent necessary to:

- state clear standards, based on objective operational conditions, for when OFOs begin and end;[97]
- require the pipeline to post, as soon as available, information about the status of operational variables that determine when an OFO will begin and end;[98]
- state the steps and order of operational remedies that will be followed before an OFO is issued to assure that the OFO has the most limited application practicable and to limit the consequences of its imposition;[99]
- set standards for different levels or degrees of severity of OFOs to correspond to different degrees of system emergencies the pipeline may confront;[100] and
- establish reporting requirements that provide information after OFOs are

[94] Standards For Business Practices Of Interstate Natural Gas Pipelines, Order No. 587–G, 63 FR 20072 (Apr. 23, 1998), III FERC Stats. & Regs. Regulations Preambles ¶ 31,062 (Apr. 16, 1998).

[95] Panhandle Pipe Line Co., 82 FERC ¶ 61,163, at 61,600–601

[96] *See, e.g.,* NorAm Gas Transmission Company, 79 FERC ¶ 61,126, at 61,546–47 (1997); Southern Natural Gas Company, 80 FERC ¶ 61,233, at 61,890 (1997) Northern Natural Gas Company, 77 FERC ¶ 61,282 (1997); Panhandle Eastern Pipeline Company, 78 FERC ¶ 61,202 (1997); Northwest Pipeline Company, 71 FERC ¶ 61,315 (1995).

[97] For example, if a pipeline anticipates an OFO will be in effect until weather conditions change, it would aid shippers' planning to so advise them.

[98] For example, if an OFO will remain in effect until repairs are completed on a compressor, the pipeline should be required to update shippers on the status of the repairs.

[99] For example, one requirement would be that a pipeline provide as much advance warning as possible of the conditions that may create an OFO and the specific OFO itself that would allow customers to respond to such conditions and/or prepare alternative arrangements in the event the OFO is implemented.

[100] For example, a $100 OFO penalty may be appropriated in severe cases, whereas a $25 OFO penalty may be appropriate in others.

issued on the factors that caused the OFO to be issued and then lifted.

In response to the tariff filing, parties could protest the proposals and propose alternatives for Commission consideration.

The Commission requests comments on the proposal set forth above. The Commission is particularly interested in comments on the extent to which current OFOs have created significant problems and, if so, the specific problems that were created.

The Commission also solicits comments on additional or alternative options. One such option would be to use financial incentives based on the past OFO experiences of a pipeline to minimize future imposition of OFOs. For example, a pipeline that never issues OFOs could be allowed to retain a portion of cash-out penalties, which under current Commission policy would be automatically credited to its customers. Conversely, a pipeline that frequently issues OFOs could be required to rebate a portion of the customer's reservation charges if it does not fix within a reasonable time the operational problems that give rise to frequent OFOs. The Commission solicits comments on the adequacy of such incentives and also solicits alternative incentives.

Another option would be to require automatic crediting of OFO penalties, even if the Commission retains its current policy of not requiring pipelines to credit most penalty revenues. As discussed, currently pipelines have incentive to impose OFOs as a first reaction to a system operational problem. Requiring the automatic crediting of OFO penalties would at least eliminate one potential incentive.

Another option is for the Commission to institute a program that monitors on a periodic basis the frequency of impositions by each regulated pipeline of OFOs. If the Commission determines that an individual pipeline frequently issues OFOs, the Commission could audit the pipeline's operations or establish a proceeding to determine if changes should be made to the pipeline's tariff.

The Commission solicits comments on its proposal, the alternative options, and the related questions. The Commission also solicits other alternative proposals that commenters believe merit consideration.

V. Negotiated Rates and Services

Two of the objectives of the regulatory changes proposed in this NOPR are to promote greater innovation in service offerings, and to increase the value of long-term capacity as protection against price swings in the short-term market. As explained below, allowing the negotiation of rates and services can provide the flexibility necessary to foster service innovation. The negotiation of rates and services also has the ability to increase the attractiveness of long-term capacity, so that biases toward short-term capacity are weakened. In this manner, negotiated rates and services can help achieve the Commission's goal of creating a more neutral regulatory policy with respect to short-term and long-term capacity.

Permitting pipelines to negotiate the terms and conditions of service with their customers can have several beneficial effects. First, permitting negotiated terms and conditions of service may spur innovation and creativity in the services provided, and keep natural gas transportation service from becoming stagnant. Traditional regulation does not always allow for innovation and gives regulated companies little incentive to be creative or to innovate. For example, conventional tariff procedures may inhibit the development of innovative services, since the need for such services may be immediate and may arise quickly. Therefore, presently, neither pipelines, customers, nor regulators know with certainty what innovations are feasible, or would be worth their cost.

A policy that permits pipelines to negotiate rates and terms of services together may give pipelines more incentive to innovate by allowing pipelines to charge more for innovations that customers value more. Also, the ability to negotiate rates and services may stimulate pipelines to offer service innovations that are relatively costless to provide, something they may have had little incentive to do under cost-based rates. These innovations should ultimately improve the quality of the pipelines' other tariff services, if pipelines are given incentives to maintain and upgrade these services, as well.

Second, while the negotiation of service may be useful for short-term services, its most significant use may be as a valuable risk management tool for pipelines and customers with respect to long-term contracts.

When a customer enters into a long-term contract, it must undertake a number of risks. It must bear the general market risk that the value of capacity may decrease in time, so that the customer could have acquired the capacity for a lower rate later, or the risk that the pipeline will experience a decrease in system throughput, which would drive the maximum regulated rate up. The customer must bear the regulatory risk that the rates for the capacity that it has committed to under the firm contract will increase due to, for example, the rolling-in of the costs of new capacity construction, or other general rate increases. The customer must also bear the customer-specific risk that its own need for capacity might fluctuate or disappear.

When these risks are too high for a customer, at the given rates for long-term and short-term capacity, the customer may be unwilling to hold long-term capacity contracts. In the past, shippers accepted some regulatory price risk in return for little or no gas supply risk. Now, however, shippers appear less willing to shoulder the price risks associated with long-term contracts as a result of the increased attractiveness of short-term contracts, the presence of regulatory disincentives to long-term contracts, such as the right of first refusal, and the uncertainty of potential business impacts of state retail open-access programs. The movement away from long-term contracts increases the pipeline's risk that it will not earn enough revenues during the pipeline's useful life to cover its total cost and an acceptable return on the investment in the pipeline.

Allowing pipelines and shippers to negotiate terms and conditions of service, as well as rates, may permit greater flexibility in the allocation of the shipper's risk inherent in long-term capacity contracts. Such negotiation of rates and services could permit the parties to negotiate more flexible contracts for higher rates. Other options for negotiation could include lower rates for longer contract terms, differing rates for the right to reopen the contract in specified contingencies, or varying rates for different payment schedules.

Thus, a negotiated rates and services policy may give parties the ability to negotiate terms that will reduce the shipper's risk in entering into a long-term contract, thereby increasing a shipper's willingness to execute long-term contracts and encouraging greater long-term contracting, generally. This, in turn, raises a third benefit of allowing negotiated terms and conditions of service. As the value of long-term contracts increases, and more long-term contracts are executed, problems of capacity turnback may be alleviated. Negotiated rates and services may give pipelines the ability to attract new customers and keep existing customers as long-term contracts expire, helping to ensure that pipelines are able to recover their long-term investment costs. Such negotiation is especially important as

markets increasingly define the value of capacity.

Further, certain additional, indirect benefits can result from permitting negotiated services. A policy favorable to negotiated services may facilitate the unbundling of LDC services at the state level, thereby extending customer choice to more retail markets nationwide. It may also position the gas industry to be a viable competitor of the increasingly competitive electric industry for end use customers.

While the Commission recognizes the important benefits that would result from a negotiated rates and services policy, the Commission is also mindful that significant, although probably manageable, concerns exist in permitting negotiated services. Pipelines will exercise market power if they can. The concept of negotiated rates and services—under which shippers and pipelines would be able to negotiate rates or service terms and conditions that deviate from those in the pipeline's otherwise applicable tariff—relies on the theory that shippers would be able to choose a ''recourse'' rate or service from the pipeline's tariff as an alternative to negotiating with the pipeline. In this way, the recourse service would act as a check on the exercise of the pipeline's market power. Nevertheless, the negotiation of rates and services, by its nature, gives pipelines the ability to treat customers differently, and thereby could facilitate a pipeline's ability to segregate customers and exercise market power.

A pipeline with market power might be able to force captive customers to pay for unwanted terms or conditions of service by bundling them with desired services, or to pay for basic services at premium prices. The Commission is concerned that permitting the negotiation of service could give pipelines an incentive to degrade the quality of recourse services in order to sell other services on a negotiated basis.

Another way pipelines could exercise their market power with negotiated services is by unduly discriminating against certain customers. Some level of discrimination, or differentiation, among customers is inherent to the concept of negotiating differing rates and terms of service. However, the Commission is concerned that pipelines could give undue preference to affiliates or other customers in the offering of negotiated services.

Further, the Commission is keenly aware of the natural tension that exists between allowing negotiated rates and services, on the one hand, and ensuring the tradability of capacity, on the other hand. The negotiation of terms and conditions of service could make capacity less tradable and deter the Commission's goal of promoting competition in capacity markets.

Many of these concerns were raised in response to the Commission's ''Request for Comments on Alternative Pricing Methods'' in Docket No. RM95–6–000.[101]/ These concerns were part of the reason that the Commission was reluctant, in its subsequent ''Statement of Policy and Request for Comments'' in Docket Nos. RM95–6–000 and RM95–7–000, to allow the full range of negotiation, and therefore, declined to permit the negotiation of terms and conditions of service as part of its negotiated rates policy at that time.[102]/ However, since then, the Commission has had the benefit of the additional industry comments filed in Docket No. RM95–7–000, and has undertaken a thorough review of its natural gas policies. The Commission now recognizes that the concept of negotiated rates and services, taken together with the other proposals in this document, has the potential to improve the Commission's regulatory framework for natural gas pipelines.

Given the above concerns, the Commission concludes that the benefits to increased service innovation and long-term contracting that can result from the negotiation of terms and conditions of service, together with rates, are valuable, but only if they do not come at the expense of the interests of recourse ratepayers, or hinder the development of competitive markets.

Accordingly, the Commission proposes to implement a policy permitting the negotiation of rates, terms, and conditions of service for transportation services that will be governed by a set of guiding principles designed to protect recourse and captive customers from the exercise of market power, prevent undue discrimination and preference, and foster competition in the interstate capacity markets.[103] These proposed guiding principles, as described below, will provide limits and conditions on the negotiation of rates and services that should minimize the risk of potential harm to recourse shippers and capacity markets, and thereby help ensure that the benefits of the negotiated rates and services policy outweigh such risks.

The Commission is seeking comment on whether to permit the negotiation of services in the short-term market. As the short-term market develops, it can be argued that the benefits of negotiated services are especially important to the short-term market, provided that such negotiation does not impair the tradability of short-term capacity. A number of expected benefits to the market may flow from allowing the negotiation of short-term services. Short-term peak market conditions arguably require a maximum amount of flexibility and customization for shippers. On the other hand, the Commission has not resolved how the negotiation of short-term rates and services could be coordinated with the capacity auction process proposed in this NOPR. Typically, auctions involve the trading of standardized products and services, whereas negotiated services may not be sufficiently tradable.

The Commission proposes to address this issue in the final rule, and seeks analysis and comment on the alternatives of whether to permit or prohibit the negotiation of terms and conditions of service in the short-term market. Should the negotiation of services be reserved for the long-term market? Can negotiation of services be accomplished in combination with the auction process? What effect would the negotiation of short-term services have on the tradability of short-term capacity? What are the benefits to the marketplace of permitting negotiation in the short-term market?

In addition, while the Commission is proposing in this NOPR to permit negotiated rates, terms, and conditions of service under the principles below, the Commission also proposes to conduct a generic review of the negotiated services after they have been in effect for two winter heating seasons.

A. Guiding Principles

The Commission is proposing to permit the negotiation of any rate, or term or condition of service for transportation services to the extent :

- It does not result in undue discrimination or preference;
- It does not degrade the quality of existing services;
- It does not hinder the release of capacity, or otherwise significantly reduce competition;
- Pipelines do not require customers to take negotiated transportation services tied with any unwanted sales, storage, or gathering services provided

[101] / Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, 60 FR 8356 (Feb. 14, 1995), 70 FERC] 61,139 (1995).

[102] / Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, and Regulation of Negotiated Transportation Services of Natural Gas Pipelines, 61 FR 4633 (Feb. 7, 1996), 74 FERC ¶ 61,076 (1996).

[103] *See* § 284.11 of the proposed regulations.

by the pipeline, its affiliates, or upstream or downstream entities; and

• The terms of the negotiated transactions are made publicly available.

These general guiding principles will provide the boundaries within which the industry may conduct negotiations of rates and services, and will be applied on a case-by-case basis. They will also give the Commission, and the industry, a basic foundation for evaluating future negotiated deals that cannot be envisioned currently. Establishing more specific or restrictive guidelines could limit, in the future, the degree of innovation that potentially could be achieved.

Further, the Commission proposes that if a pipeline violates any of these proposed guiding principles, the Commission would revoke that pipeline's authority to negotiate rates and services. Establishment of this penalty up-front for violating the guidelines of the negotiated rates and services policy should serve as an incentive for compliance. In addition, the traditional remedies available under the NGA would also be available to the Commission to use.

Each of the proposed guiding principles is discussed more fully below.

1. No Undue Discrimination or Preference

The Commission is particularly concerned that the negotiation of rates and services does not violate the statutory prohibition against undue discrimination and preference in the NGA.[104] The very nature of negotiated rates and services is to provide some customers rates and services that differ from those provided to others. However, the negotiation of rates and services under the proposed policy cannot be unduly discriminatory or preferential. Practically speaking, under existing undue discrimination standards, this would require that ''similarly situated'' shippers have rights to the same negotiated deal. The cases in which the Commission has applied the ''similarly situated'' standard in the past provide some guidance on the meaning of ''similarly situated'' shippers.[105]

Nevertheless, the Commission recognizes that clear guidelines, or standards, on what constitutes undue discrimination or preference in negotiating rates and services may need to be established before any negotiation takes place so that the industry can abide by this principle. Such up-front standards could provide guidance to pipelines and shippers about acceptable negotiation practices, eliminating confusion about what does and does not constitute permissible conduct, and could minimize the risk of discrimination occurring before standards emerge from a case-by-case complaint and review process. The standards may also be critical to effective monitoring and enforcement.

While the Commission is considering developing such generic undue discrimination guidelines, such standards could prove difficult to craft, since undue discrimination findings usually depend on specific facts and often are subject to widely varied and subjective interpretation. Thus, the Commission seeks comment on the need for, and feasibility of, its developing clear standards on what constitutes undue discrimination or preference before negotiations are permitted to occur. The Commission further requests commenters to discuss what should be the standards for undue discrimination, including whether the ''similarly situated'' standard should continue to be used, and if so, how that term should be defined.

2. No Degradation of the Quality of Existing Services

A core concern of captive customers, shared by the Commission, is the effect a negotiated rates and services policy could have on the quality of service that recourse shippers receive. Permitting the negotiation of particular terms and conditions of service might, in a direct way, adversely affect the quality of one or many recourse shippers' service. For example, negotiations to loosen a pipeline's imbalance provision for some shippers may force the tightening of allowed tolerances for others.

Therefore, the Commission proposes to permit the negotiation of rates and services as long as the quality of service for recourse shippers is not diminished or degraded. The Commission's objective in proposing this principle is to prevent pipelines from negotiating services at the expense of service quality for recourse shippers.

3. No Impairment of the Tradability of Capacity

The negotiation of terms and conditions of service could impair or reduce competition in capacity markets. This may happen either because service may become defined so differently that capacity is no longer fungible, or because customers voluntarily give up the rights that make trading possible in exchange for a rate reduction. This, in turn, could diminish the degree of competition in capacity markets generally, or in some specific markets.

Therefore, to guard against this, the Commission proposes to permit the negotiation of rates and services as long as such negotiation does not impair tradability of capacity, result in a significantly greater concentration of sellers in capacity markets, or otherwise significantly reduce existing competition. Since the full range of innovation that might occur under the negotiated rates and services policy cannot be known at this time, it may be that shippers will be able to develop negotiated services that do not impair the tradability of capacity. To help enable shippers to release negotiated services, mechanisms may be developed which allow negotiated service to revert to standard service at the releasing shipper's option when released to another shipper.[106]

4. No Unwanted Tying Arrangements

One of the Commission's objectives in Order No. 636 was to prevent the exercise of market power over transportation from being extended to the sale of natural gas, through the tying of the two different services. The negotiation of terms and conditions of service can raise new issues in this regard. Permitting pipelines to negotiate individualized services may prompt pipelines to require customers to take packages of service, either from the pipeline, its affiliate, or another entity,

[104] *See* Section 4(b) of the NGA. 15 U.S. C. 717c (1994).

[105] *See* Tennessee Gas Pipeline Company, 77 FERC ¶ 61,877 (1996) (requiring the pipeline to file specific information to enable shippers to determine if they are similarly situated to particular negotiated rate customers, including the type of service, the receipt and delivery points applicable to the service, and the volume of gas to be transported); and Standards of Conduct and Reporting Requirements for Transportation and Affiliate Transactions, 59 FR 32885 (June 27, 1994), FERC Stats. & Regs. ¶ 30,997 at 31,067–68 (1994) (Order No. 566) (requiring pipelines to post particular information on their EBBs regarding affiliate discounts, including quantity and point data, to enable non-affiliates to determine if they are entitled to a similar discount). *See also,* Iroquois Gas Transmission System, L.P., 79 FERC ¶ 61,394 (1997), *reh'g denied,* 82 FERC ¶ 61,086 (1998) (holding that the pipeline may not charge new expansion shippers and existing shippers different rates, based on findings that differences between each shipper group stemming from the time when each group came on the system, such as differences in receipt and delivery points or available competitive alternatives, were insufficient to justify disparate treatment); and El Paso Natural Gas Company, 62 FERC ¶ 61,311 at 62,990–91 (1993), *followed in* ANR Pipeline Company, 66 FERC ¶ 61,340 at 62,130–31 (1994) and Questar Pipeline Company v. PacifiCorp, 70 FERC ¶ 61,328 at 62,009 (1995) (shippers holding discounted rate contracts between certain primary points do not have the right to use alternate points at the discounted rate, since the market conditions may not be the same at the primary and alternate points).

[106] This is discussed more fully below.

that include both transportation and sales services that are currently available separately. Similar concerns arise from attempts to bundle transportation with unwanted storage or gathering services. Allowing pipelines to force customers to take tied services could adversely affect commodity markets that are currently competitive, or competition between sellers of capacity, and could lead to increased preferences for affiliates.

Therefore, the Commission proposes that a pipeline may not require that a negotiated transportation service be tied with any unwanted sales service or other services provided by the pipeline, its affiliate, or by any upstream or downstream entity, unless that service is necessary to the provision of the negotiated transportation service. While the Commission does not envision that the tying of gathering or sales service to the transportation service would be necessary to the transportation service, there may be instances where storage service could be a prerequisite for the pipeline's ability to provide the negotiated transportation service.

5. Transparency of Negotiated Transactions

The Commission proposes to require that the essential elements of negotiated transactions, including price, be transparent to the public and the Commission. The full disclosure of the terms of the negotiated transactions is critical to the ability of shippers and the Commission to detect, and deter, the exercise of market power and undue discrimination and preference. The transparency of negotiated arrangements also enables shippers to make informed purchasing decisions.

The need for transparency has guided the Commission's development of the proposed procedures for implementing a negotiated rates and services policy. Thus, as discussed *infra*, the Commission is proposing to require pipelines to file with the Commission and serve on firm shippers, written notice of all essential information about a negotiated transaction prior to the transaction taking effect. The Commission is also proposing to increase its existing reporting requirements.

B. Implementation of the Negotiated Rates and Services Policy

1. Procedural Mechanism

The American Gas Association (AGA), on behalf of itself and the Interstate Natural Gas Association of America (INGAA), proposed to the Commission, by letter dated May 4, 1998, a method for implementing a negotiated services policy. AGA/INGAA's proposed method would entail each pipeline making an initial ''benchmark'' filing, prior to its first negotiation of service, that would (a) set forth certain terms or conditions of service that could not be negotiated absent 30 days prior notice, and (b) establish a high standard for quality and reliability of recourse service, as well as better define essential elements of the pipeline's tariff. Then, after Commission approval of the initial benchmark filing, the pipeline would be able to implement, after 10 days prior notice, negotiated deals containing items not identified in the initial filing as requiring 30 days prior notice. The Pipeline Transportation Customer Coalition (Coalition), comprised of end users, marketers, producers, and municipal distributors, filed with the Commission a letter opposing AGA/INGAA's negotiated services proposal and more broadly, the concept of negotiated services.[107]

As discussed above, the negotiation of rates and services can serve a valuable role in the Commission's proposed new regulatory approach. While the Commission acknowledges the potential risk of harm to competitive markets and recourse shippers, that risk appears to be manageable. Therefore, the Commission is proposing a method for implementing negotiated services that has some similarity to aspects of AGA/INGAA's proposed method.

The Commission is proposing to require a pipeline interested in negotiating terms and conditions of service to make an initial filing requesting authority to negotiate rates and services on its system. This initial filing would accomplish two equally important functions. First, it would define and establish a high quality recourse service.[108] Second, the initial filing would establish the parameters of permissible and impermissible negotiation for that pipeline in advance of any negotiation of service or implementation of negotiated services. This would be accomplished by the pipeline identifying categories of non-negotiable, negotiable, and potentially negotiable terms or conditions of service, as described in more detail below. The Commission would closely scrutinize the proposed categories of terms and conditions of service, particularly the terms and conditions of service included within the negotiable category, to ensure consistency with the proposed guiding principles. For example, the Commission would analyze whether the negotiation of the negotiable items could adversely affect the quality of other services or the tradability of capacity, and whether additional terms and conditions should be included in the non-negotiable category. Interested parties would have the opportunity to comment on and protest any aspect of the initial filing, and the Commission would carefully consider all such comments and protests. Only after such review, and Commission approval of the initial filing, would the pipeline be permitted to begin negotiations and implement negotiated services. In addition, after the Commission approved the initial filing, the pipeline would be required to include the categories of terms and conditions of service in its tariff.

The non-negotiable category of terms and conditions of service would include certain terms and conditions of service that could never be negotiated, and thus, would be *per se* non-negotiable. A pipeline might include in this category terms or conditions that, by their nature, would directly affect the services of other shippers (*e.g., force majeure,* higher curtailment, or generic OFOs provisions).

The negotiable category of terms and conditions of service would include particular items that the pipeline would be permitted to negotiate, at its and its customers' discretion. A pipeline could include permissible ranges of flexibility for each negotiable area of service. These negotiable deals would be permitted to be implemented after 10 days prior written notice to firm shippers and the Commission.[109] The Commission is proposing to permit these negotiable services to go into effect at the end of the 10 day notice period, without action on the notice filing by the Commission, since the Commission would have already generically approved the negotiation of these items by that pipeline with its action on the initial filing. Similarly, other shippers would have had the opportunity to comment on or oppose the pipeline's proposed negotiation of a particular term or condition of service at the initial filing stage.

The Commission, however, seeks comment on whether a shorter advance notice period, or any advance notice at all, is necessary for contracts containing the items identified by the initial filing as negotiable. Parties should comment on whether such negotiated contracts could be self-implementing, becoming

[107] *See* June 17, 1998 letter of the Pipeline Transportation Customer Coalitation filed in Docket No. PL97–1–000.

[108] Further discussion of this aspect of the proposal is included in the discussion below on the establishment of initial recourse service.

[109] *See* 18 CFR 385.2007 (1998).

effective upon the agreement of the pipeline and the shipper, subject only to the pipeline filing and posting a transactional report of the negotiated deal contemporaneous with the execution of the contract.

The potentially negotiable category of terms and conditions of service would not need to be specifically identified, but would encompass all other terms and conditions of service not identified in the non-negotiable or negotiable categories. Items would fall into this category if they had the potential to have an impact on the service of other shippers, or had the potential to violate one of the other guiding principles. Thus, any negotiation of these unspecified terms and conditions of service would require prior notice, an opportunity for other shippers to comment, and Commission review of the particular negotiated transaction before taking effect. Specifically, the pipeline would be required to make a filing under Sections 4(d) and (e) of the NGA before the negotiated deal could take effect.[110] The 30 days prior written notice to the Commission and firm shippers provided by the Section 4 filing would give all other shippers the opportunity to protest the negotiated transaction before it takes effect, and the Commission would have the ability, as usual, to accept, reject, or suspend the pipeline's filing.

The pipeline's Section 4 filing would need to contain the essential aspects of the negotiated agreement, including: the name of the shipper, any affiliation with the pipeline, the contract quantity, the applicable rate(s), the receipt and delivery points, and a brief description of the negotiated term or condition of service with reference to the modified provision of the recourse tariff or rate schedule. The filing would also contain a statement, with any supporting information, that no material adverse effects on the benchmark service will result from the negotiated term or condition. This statement and supporting information would create a rebuttable presumption that the negotiated transaction will not have any material adverse effect on the recourse service. If the presumption is overcome, the ultimate burden of persuasion would be on the pipeline to show that no degradation of the recourse service would result.

Finally, the Commission is also proposing to continue the current practice of allowing pipelines to negotiate unique services in individual rate schedules that are then made available to all customers, since this method already serves the industry well.

Although the Commission is proposing the method for implementing negotiated services described above, the Commission would also consider variations on this method, including the specific proposal advanced by AGA/INGAA. In this regard, the Commission requests comment on whether pipelines could be given an option of implementing negotiated terms and conditions of service without having to initially file general tariff provisions defining the scope of permissible or impermissible negotiation. That is, could pipelines also be permitted to negotiate unique deals with individual shippers that include terms and conditions that deviate from those in its existing tariff, by filing each negotiated contract with 30 days advance notice, and bypassing the initial tariff filing? The Commission invites comments discussing the pros and cons of the proposed implementation method, including whether that method adequately addresses concerns which have been expressed about the pipelines' potential exercise of market power. Commenters are also invited to suggest alternative procedures for implementing negotiated rates and services.

2. Recourse Service

The recourse service, which would be available to all shippers, serves as an alternative to negotiating with the pipeline, and an important check on the pipeline's potential exercise of market power. Therefore, the Commission must ensure that the recourse service is initially, and remains over time, a high quality service, so that it stays a viable alternative to negotiated rates and services. Below, the Commission presents proposals for initially establishing a good quality recourse service, and for maintaining the vitality of that recourse service in the future.

a. Establishment of Initial Recourse Service. The Commission proposes to require that each pipeline's initial voluntary filing to implement negotiated terms and conditions of service define the components of that pipeline's recourse service. Pipelines would be required to design a recourse service that is of a high quality and reliability, and maintains at least the level of service being offered by the pipeline in its currently effective tariff. Core elements of the pipeline's recourse service that are not adequately defined in the tariff, including standard operating practices, would be identified by the pipeline or its customers in conjunction with the filing.

Essentially, this method of establishing initial recourse service would require that any pipeline choosing to implement negotiated terms and conditions of service submit its tariff services for review and modification to establish adequate recourse service in exchange for the authorization to negotiate terms and conditions of service. This proposal would provide a procedure to address shippers' dissatisfaction with some pipelines' existing service offerings, and their concerns that the literal language of the existing tariffs might permit pipelines to reduce the quality of recourse service from that enjoyed under current operating practice. Thus, the review and modification of individual pipelines' existing tariff services will help ensure that recourse service is adequate before any negotiation of rates or services takes place.

However, the Commission also seeks comments on whether using pipelines' existing tariffs as the initial recourse service, without requiring new filings, might be less burdensome on the industry and the Commission, and thereby permit pipelines and shippers to begin negotiating rates and services sooner than if initial filings to establish recourse service were required. Parties should also comment on whether the existing rates, terms, and conditions in pipelines' current tariffs could be acceptable as initial recourse services, since they have already been found by the Commission to be just and reasonable. In commenting, parties should evaluate the need for establishing adequate recourse services against the ability to implement the negotiated rates and services policy without undue delay.

Another option for establishing initial recourse service would be to have GISB generically identify basic elements of service that could not be subject to negotiation. Designating particular terms or conditions as non-negotiable would have the effect of defining some of the basic terms and conditions of service that comprise recourse service. Some commenters have requested that the Commission generically specify particular terms or conditions as non-negotiable. However, GISB is the one forum where all segments of the industry are brought together, making across-the-board consensus on this issue a possibility. The Commission requests comments on the feasibility and value of having GISB define initial recourse service.

b. Maintaining Vitality of Recourse Service Over Time. For recourse service to remain a viable option to negotiated

[110] 15 U.S.C. 717c (1994).

service, the overall quality of the recourse service must continue to meet shippers' needs. The Commission is concerned that over time the quality of recourse service may deteriorate. By not updating recourse service to keep pace with changing markets, technology, and customer needs, or by maintaining a low-quality or inferior recourse service, pipelines could force captive customers into negotiating the basic services they need, at premium rates.

Thus, the Commission finds that a mechanism needs to be established to review recourse services to ensure they remain viable alternatives to negotiated services. Accordingly, the Commission proposes to implement periodic reviews of the rates, terms, and conditions of recourse service.[111] As discussed in more detail below, the Commission proposes that these periodic reviews take place on a three-to-five year cycle, although comment is invited on proposals for alternative review cycles. These periodic reviews would provide the Commission with the opportunity to examine the range of terms and conditions included in the recourse service, and to assess the quality of the recourse service as a whole.[112]

The periodic reviews would provide a forum for the Commission to determine if certain negotiated services offered by some pipelines should be offered as recourse services after some reasonable time. This would allow captive customers to obtain the benefits of service innovation, while at the same time giving pipelines a reasonable period of time to profit from their innovative service offerings before having to offer the service at a cost-based rate. The periodic reviews of recourse services would also enable proposed additions or changes to recourse service to be considered comprehensively, to help ensure that the new package of recourse services is both operationally feasible and cost effective.

There are several different ways that the Commission could implement the periodic reviews of recourse service. The periodic review could be undertaken on an individual pipeline basis, on a regional basis, or on a national, or generic, basis. The Commission proposes to establish recourse services, through the periodic reviews, for each individual pipeline. This approach is likely to provide the best match of customers' service needs with the operational capabilities of individual pipelines. Establishing recourse services individually, for each pipeline, would also allow rate issues to be treated simultaneously with service issues.

The Commission proposes that pipelines offering negotiated terms and conditions of service file information with the Commission every three to five years that will ensure the viability of the pipeline's recourse service. The information proposed to be filed is intended to give the Commission adequate information to determine whether and how to modify the pipeline's recourse rates and service to keep pace with market conditions.

The information would need to be filed for each type of negotiated service—the negotiated services that take effect on shortened notice and the transactions subject to 30 days notice. The filing would include data on the names and types of shippers negotiating the contracts, the terms negotiated, the contract demand, and volumes moved under the contracts.

In addition, to permit a comparison to the pipeline's current recourse service, the pipeline would have to provide aggregate data for each category of negotiated service, and for the recourse service. The aggregate data would include information on total contract demand, aggregate volumes, and revenues for the negotiated contracts and the recourse service.

Commenters are requested to address the adequacy of the information required in the proposal, including whether more detailed information is necessary, and are encouraged to suggest other information that might better permit the Commission to review negotiated rates and services.

The Commission is still considering, as an alternative to the pipeline-specific review of recourse service, requiring the periodic recourse service reviews to be made on a regional basis, before any individual pipeline-specific adjustments are made. On the one hand, the establishment of recourse services on a regional basis, so that the recourse services offered by all pipelines in a given region would be as nearly equivalent as possible given operational differences among pipelines, could result in greater standardization of pipeline services and practices, thereby enhancing competition and tradability of capacity. It could also lower transaction costs for customers. In addition, a regional approach may be less burdensome on shippers because they would need to participate in fewer proceedings. On the other hand, it may be difficult to develop recourse services for all pipelines in a region, since a regional approach would not facilitate the tailoring of services to the operational capabilities of specific pipelines.

The Commission seeks comment on the different ways that the Commission could implement the periodic reviews of recourse service, including comment on the merits of establishing recourse service on a regional basis through regional reviews. Parties may discuss the advantages and disadvantages of each approach, and how a regional approach might be performed.

3. The Release of Negotiated Capacity

To enhance the tradability of capacity under negotiated service contracts, the Commission is contemplating requiring pipelines to include in their tariffs a provision that allows, but does not require, a negotiated service to revert to a standard form of service when it is offered for release. This should make it easier for the customer under a negotiated service contract to release its capacity. This is because a negotiated service agreement may contain provisions tailored to a customer's needs which render the service undesirable to other shippers with different needs. This provision could apply either to all negotiated services, or only to those that represent an enhancement over the standard service. The provision could also be structured such that any negotiated term or condition of service which the replacement shipper desires would remain in the contract.

In the case where a releasing shipper negotiates enhanced, more flexible, or ''better'' services than the standard service, the releasing shipper presumably would be compensated for reselling capacity as if it was standard service, regardless of what it paid for the capacity. If negotiated services are below the standard level included in the tariff provision, the releasing shipper might be required to pay the difference between the negotiated rate and the standard rate before reselling its service as standard service. In both cases, reversion of a negotiated service to a standard form of service would be allowed only when operationally feasible, and only when requested by the releasing shipper.

The Commission requests comment on this potential method for helping ensure that negotiated capacity remains tradable, particularly on the feasibility of implementing such a requirement. Commenters should address how critical establishing this reversion requirement is to permitting the release of capacity under a negotiated contract, how difficult it would be to define what

[111] *See* proposed § 284.10(c).

[112] The Commission may need, at some point in the future, to adopt standards that define recourse service quality.

service is of a higher or lower quality than the standard level of service, and to what extent operational difficulties in permitting the reversion to a standard form of service might limit the overall value of this approach.

4. Negotiation of Rates and Services With Affiliates

As stated previously, the Commission proposes to permit the negotiation of rates and services where similarly situated shippers have rights to the same negotiated deal. The Commission is considering whether additional protections are required to protect against unduly preferential treatment in favor of pipeline marketing affiliates or whether the Commission's existing marketing affiliate rules provide adequate protections. Therefore, the Commission proposes to permit pipelines to negotiate terms and conditions of service with their marketing affiliates so long as all other similarly situated shippers are offered the same rates and services. Consistent with prior precedent, the Commission proposes to establish a rebuttable presumption that all shippers receiving the same type of service, using the same pipeline facilities, are similarly situated.[113] The pipeline could rebut the presumption by showing that a particular shipper or group of shippers is not similarly situated with its affiliate in order to justify not offering the same negotiated deal to non-affiliated shippers.

The Commission seeks comments on whether the above proposal provides adequate protection against undue discrimination. For example, should the Commission consider stronger protections, such as precluding the negotiation of rates and services with marketing affiliates as unduly preferential unless all other shippers are offered the same rates and services? Alternatively, could robust monitoring be adequate to discourage and prevent pipelines from giving undue preference to their affiliates eliminating the need for stronger protections? If so, what types of information would the Commission need to gather to meet its monitoring objectives, and how burdensome would it be to provide this information? Is some other form of protection better suited to the Commission's purpose of ensuring against undue discrimination? Commenters are invited to respond to these issues and may raise any related issues not presented here.

5. Negotiation of Capacity Release and Flexible Point Rights

The Commission is considering whether the rights to release capacity and to flexible receipt and delivery points should be included among the terms or conditions of service that could not be changed by negotiation. Capacity release is a fundamental element of the increasingly competitive natural gas capacity market. It creates competition between firm capacity holders and the pipeline in what otherwise may be a monopoly capacity market.

Under a negotiated rates and services policy, both pipelines and shippers may find it easy and advantageous to negotiate the relinquishment of such rights. Pipelines may find it in their interest to negotiate services without capacity release rights to reduce competition for their interruptible and short-term firm services. Shippers, also, may wish to relinquish capacity release rights for a price break, particularly if they do not plan to utilize their release rights. Shippers who give up capacity release rights will no longer be potential sellers of capacity. Those who give up flexible receipt and delivery points may severely limit their participation in the secondary market. Thus, surrender of these rights could have a clear and direct impact upon competition from the release market and the pipeline's ability to exercise market power.

The Commission requests comment on whether precluding the negotiation of rights to capacity release and flexible points is necessary to ensure that firm shippers can continue to release capacity and trade with others behind secondary points, and thereby remain competitors in the short-term capacity market. Commenters should address the likelihood, and extent to which, they expect these rights to be a primary subject of negotiations between pipelines and shippers, and the extent to which restricting the negotiation of such rights might limit the range of possible negotiated deals. Commenters also should consider whether the Commission should implement this restriction as an initial protection that could be relaxed in the future as more experience is gained with the negotiated rates and services policy.

6. Future Cost Allocation Issues

The Commission shares concerns, voiced by potential recourse shippers in the comments filed in Docket No. RM95–7–000, regarding the effect that the negotiation of rates and services might have on recourse shippers' rates. The main concern is that pipelines entering into negotiated deals that result in reduced revenue streams might seek to recover the revenue shortfall by raising recourse rates in future rate cases. Such cost-shifting could cross-subsidize negotiated services, and pipelines could try to keep revenues that exceed recourse rate caps, while shifting revenue shortfalls to recourse ratepayers.

The rates of recourse shippers should not be adversely affected by the pipelines' negotiations of service with other parties. Only the negotiating parties should bear the risks and rewards of their negotiated contracts. In fact, the Commission has previously addressed this issue in the negotiated rates context by prohibiting a pipeline from making any adjustment to its recourse rates to account for its failure to recover costs from a negotiated rate shipper,[114] absent some showing of benefit to recourse shippers.[115]

At the same time, the Commission is concerned that if discount-type adjustments for negotiated services are similarly prohibited in future rate cases, pipelines might be deterred from negotiating rates and services. Pipelines might favor the discounting of service fees over the negotiation of creative alternatives, since the Commission's discounting policies permit the recovery of revenue shortfalls. These lost negotiated agreements may have resulted in the pipeline obtaining a higher total revenue stream than it would have by entering into a discounted deal, and may have mitigated the losses associated with the level of discounting reflected in current rates. All customers may benefit to the extent that some shippers stay on the system or take longer term contracts as a result of the ability to negotiate rates and services.

Therefore, the Commission is considering examining all rate issues associated with negotiated rates and services in future rate cases, including the treatment of revenue shortfalls and excess revenues, and whether corresponding rate adjustments are appropriate. This would be a change from the policy stated in *NorAm* of prohibiting, *per se*, discount-type adjustments for negotiated rate agreements as a means of ensuring costs

[113] *See* Tennessee Gas Pipeline Company, 77 FERC at 61,877 (requiring the pipeline to file specific information to enable shippers to determine if they are similarly situated to particular negotiated rate customers), *see also*, Iroquois Gas Transmission System, L.P. CP96–687–000, 79 FERC ¶ 61,394 at 62.693 (1997), *reh'g denied*, 82 FERC ¶ 61,086 (1998) (rejecting proposal to discount service to expansion shippers as unduly discriminatory against existing shippers).

[114] NorAm Gas Transmission Company, 75 FERC ¶ 61,091, *order on reh'g*, 77 FERC ¶ 61,011 (1996) (*NorAm*).

[115] Northwest Pipeline Corporation, 79 FERC ¶ 61,416, 62,754 (1997).

are not shifted to recourse rate customers. This approach may also permit the Commission to consider any additional cost allocation issues that might arise from any new facilities that may have been built to provide the negotiated service. However, the burden of justifying the benefit of specific negotiated deals would be on the pipeline. In this respect, the Commission seeks comment on what type of showing pipelines would have to make in order to show that specific negotiated deals merited an adjustment to recourse rates.

Finally, the examination of all rate issues associated with negotiated terms and conditions in future rate cases may also provide the Commission with the opportunity to fully explore the benefits and/or harm to the recourse shippers from the negotiated rates and services policy. To the extent that these are unknowns at this point, the Commission needs to have a fair amount of flexibility to decide how revenues and costs associated with negotiated services should be treated in future rate cases. The Commission solicits comment on the above proposal, including comment on the extent to which this approach may lead pipelines to attempt to shift risks to captive ratepayers, and the proposal's potential impact on the ratemaking process.

An alternative would be to prohibit any adjustments to recourse rates due to revenue shortfalls resulting from negotiated rates and services. This approach would prevent pipelines from shifting the risks of negotiated deals to recourse ratepayers. On the other hand, if the pipeline were required to absorb any revenue shortfalls from negotiated deals, the pipeline should probably have a corresponding right to retain any excess revenues resulting from negotiated rates, thus eliminating the possibility that recourse shippers would benefit from negotiated deals other than through improved recourse service.

The Commission seeks comment on the advantages and disadvantages of this alternative proposal to prohibit rate adjustments to recourse rates for revenue shortfalls. Commenters should include discussion on the extent to which prohibiting rate adjustments might discourage pipelines from entering into negotiated deals, and whether, and/or to what extent, prohibiting rate adjustments is inconsistent with the Commission's existing discount policy.

7. Reporting, Monitoring, and Complaint Procedures

The implementation of stringent reporting requirements and active monitoring will be necessary to ensure the success of a negotiated rates and services policy. Such reporting and monitoring will be critical for the Commission to be able to detect and deter the exercise of market power, for customers to identify undue discrimination in the provision of services and to support their legitimate complaints, and for the Commission to ensure compliance with the guiding principles of the negotiated rates and services policy.

The Commission is proposing to add to the data that pipelines currently are required to report under the Index of Customers. Such additional information will be aimed at capturing the existence of similarly situated customers and any affiliate relationship between the capacity holder and the customer in a negotiated transaction.

Specifically, the Commission proposes to require pipelines to identify, in the Index of Customers, each contract that contains negotiated rates and services. Pipelines would only be required to flag contracts with negotiated rates and services through a ''yes/no'' indicator and contract number for each customer and contract. The Commission is not proposing to require pipelines to delineate the terms of specific contracts in the Index of Customers. Such delineation might pose a significant burden on the pipelines, without a substantial countervailing benefit.

In addition, the Commission is proposing to require other information in the Index of Customers and/or the proposed monthly transaction reports to assist in monitoring a pipeline's market power. This includes information on receipt points, delivery points, segments, affiliate relationships, and contract numbers. Such information will enable shippers and the Commission to evaluate whether specific shippers or transactions are ''similarly situated'' for purposes of assessing undue discrimination or preference under a negotiated contract.

Further, the Commission proposes to conduct compliance audits or studies of specific pipelines' compliance with the principles. Compliance audits or studies may provide the necessary detail about specific services offered, and their effects on the customers in individual cases, to allow case-by-case review of complaints, the early detection of problems, and *sua sponte* Commission action. Such audits also could provide constructive feedback to both the industry and the Commission, and may improve overall compliance. The Commission seeks comments on the utility of compliance audits.

Finally, an effective complaint procedure is necessary to resolve and discourage abuses of the negotiated rates and services policy. To this end, the Commission recently held a public conference in Docket No. PL98–4–000, to aid in the process of evaluating and improving its complaint procedures,[116] and is contemporaneously issuing a separate NOPR to revise the complaint process in Docket No. RM98–13–000.

AGA/INGAA's negotiated terms and conditions proposal recommends that an expedited and effective complaint procedure allow for the remedy of retroactive relief in the event a customer proves that the pipeline willfully and knowingly made a material misrepresentation in its initial filing of a negotiated term or condition, which resulted in material harm to the customer. Such relief would only be available in the context of the negotiated terms and conditions policy, and would not be permitted to be used as precedent for any other matter under any statute administered by the Commission. Parties may also comment on this proposal in the separate rulemaking proceeding in Docket No. RM98–13–000.

VI. Long-Term Services

The proposals made in this NOPR for the short-term capacity market will necessarily impact the long-term market. Further, without a vibrant market for long-term capacity, the benefits of the short-term market proposals cannot be realized. If the Commission adopts a new regulatory approach for short-term transportation, there must be viable, regulated long-term services available to mitigate any market power of capacity sellers. The Commission is issuing a companion Notice of Inquiry [117] to consider whether changes should be made in its policies with regard to long-term markets. However, the Commission is concerned that some of its current regulatory policies may result in a bias toward short-term contracts, which could weaken the long-term market and undermine the proposals set forth in this NOPR.

Therefore, the Commission is addressing in this NOPR, several long-term transportation rate and certificate issues that have a direct and significant impact on the short-term transportation policy proposals contained in this NOPR. Specifically, the Commission is

[116] Symposium on Process and Reform: Commission Complaint Procedures. *See* Notice of Conference issued March 10, 1998 in Docket No. PL98–4–000, 63 FR 12800 (March 16, 1998).

[117] Regulation of Interstate Natural Gas Transportation Services, Docket No. RM98–12–000.

proposing to modify the right of first refusal by eliminating the term matching cap. Further, the Commission is considering changes to its policies with regard to term-differentiated rates and negotiated terms and conditions in long-term contracts. In addition, the Commission is seeking comments on its policies for certification of new capacity.

A. The Interaction Between Long-Term and Short-Term Services

Long-term contracts provide important benefits to pipelines and customers. Long-term contracts provide stability, and can reduce financial risks to the pipeline, lowering their capital costs, to the benefit of all the pipeline's customers. In addition, encouraging long-term contracts ensures that there will be sufficient capacity available for release in the secondary market in order to maintain the vibrant competition between sales of capacity in the primary and secondary market which exists today.

The Commission has proposed that the removal of the price cap in the short-term transportation market, coupled with other changes proposed for the short-term market, would be consistent with the Commission's statutory responsibilities. These proposals, in combination with one another, should foster a more competitive environment, while at the same time, providing a check against any monopoly power abuses. The rationale for modifying the approach to short-term markets does not apply to the long-term market, however. In the long-term market, there are no effective substitutes for long-term pipeline service, unlike the short-term capacity products of interruptible, short-term firm, and capacity release. Therefore, even if the Commission decides to adopt a different regulatory approach for short-term transactions, there will continue to be a need for the Commission to regulate the terms and conditions of service for long-term transportation to protect shippers against the exercise of monopoly power by pipelines. The Commission's regulation, however, should not provide artificial disincentives for long-term contracts, but should be neutral with regard to long-term and short-term contracts.

The Commission is concerned that some of its current regulatory policies result in a bias toward short-term contracts. These policies include the term matching cap in the right of first refusal and the use of the same maximum rate for service under short-term and long-term contracts. Under these conditions, financial risks and rewards are not linked, *i.e.*, there is risk asymmetry, favoring short-term contracts, and there is little incentive for a shipper to enter into a long-term contract with the pipeline. If a shipper enters into a long-term contract, it runs the risk that its rates will increase during the term of that contract. It can avoid this risk, and still be guaranteed that it can receive service indefinitely by entering into a short-term contract with a right of first refusal. The customer knows that it need never pay more than the regulated cost-of-service maximum rate to buy service from the pipeline, regardless of whether it is pursuant to a long-term or a short-term contract. If market conditions are relatively weak at the end of the current contract, the customer may be able to bargain with the pipeline to get a discount or to obtain service more cheaply through the secondary market or on another pipeline. Where capacity holders have firm rights to capacity that is valued above the cost-of-service rate, they will likely hold onto that capacity. Current contract holders will exercise their right of first refusal when market conditions are weak. Other things being equal, the customer should want a shorter-term contract.

The pipeline faces the other side of the bargain. The bias toward short-term contracts and the current asymmetry of risk may have negative economic consequences to the pipelines, and for example, may be a factor in causing capacity turn-back and the discounting of rates for long-term contracts. Customers may take only relatively short-term contracts and only when the value meets or exceeds the rate. The proposed removal of the price cap in the short-term market could move some customers toward longer-term contracts to avoid price uncertainties and potential jumps in the short-term prices. On the other hand, however, removal of the price cap could move other customers toward the short-term market because they could always count on being able to secure capacity there at some price. Cost recovery problems resulting from a weak long-term transportation market could be a possibility for pipelines, even if the price cap were removed, given the biases toward short-term contracts. Without changes in the Commission policies that contribute to this bias, the Commission's goals for the short-term market could be undermined because pipelines would have an incentive to undermine short-term markets in order to be more confident of their ability to recover their costs over the long term.

A pipeline with cost recovery problems could try to alleviate the problem in one of several ways, each of which would have adverse consequences on the short-term market. First, to try to recover their revenues, pipelines could attempt to raise the charges to remaining long-term customers. They are unlikely to be able to recover their costs in this manner. Even if successful in raising rates to remaining customers,[118] this action could cause additional customers to leave the pipeline, leaving the pipeline and the remaining customers in an even worse financial situation.

In addition, a pipeline with a cost recovery problem would feel pressure to eliminate alternatives that enable shippers to turn back capacity.[119] If pipelines can make the secondary market less viable, by withholding capacity and/or price discrimination, they would have more captive customers from whom to recover their costs. This would undermine short-term markets and reduce efficiency because shippers' capacity could not be reallocated to those who value it more. It would also give pipelines greater opportunity to exercise market power, further decreasing efficiency, and making it easier for a pipeline to maintain a policy of discrimination between customers. Thus, by having a negative impact on the pipeline's financial stability, the bias in favor of short-term markets would provide incentives for the pipelines to undermine the short-term market.

B. Specific Impediments to Long-term Contracts

There are a number of artificial impediments to long-term contracts on existing pipelines. These result in lower risks to shippers for short-term contracts available for the same maximum rates as the long-term contracts, thereby artificially discouraging long-term contracts. One way to help restore balance is to remove these artificial impediments to long-term contracts.

1. The Right of First Refusal

In Order No. 636, the Commission authorized pre-granted abandonment of long-term firm contracts, subject to the right of first refusal for the existing

[118] The Commission would not necessarily approve a request for increased rates. *See, e.g.*, El Paso Natural Gas Company, 72 FERC ¶ 61,083 at 61,441–42 (1995); and Natural Gas Pipeline Co., 73 FERC ¶ 61,050 at 61,128–30 (1995).

[119] Pipelines might also try to increase their sale of interruptible transportation as another means of recovering their costs of service. Shippers, however, would only take this capacity when they need it, and not year round in most cases.

shipper.[120] Pursuant to the right of first refusal, the existing shipper can retain service by matching the rate and length of service of a competing bid. The rate is capped by the pipeline's maximum tariff rate, and, in Order No. 636–C, the Commission limited the requirement that the existing shipper must match the length of the contract term of a competing bid to a contract length of five years.[121] On rehearing of Order No. 636–C, the pipelines argued that this five-year matching cap interferes with market forces; and, because of the five-year cap, it is unlikely that any existing shipper will renew its contract for more than five years. While the Commission concluded that the record in the Order No. 636 proceeding supported the five-year cap, the Commission recognized there are legitimate concerns about the practical effects of the five-year matching cap on the restructured market as it continues to evolve.

The right of first refusal with the five-year matching cap provides a disincentive for an existing shipper to enter into a contract of more than five years, and results in a bias toward short-term contracts. As a practical matter, the right of first refusal with the five-year cap gives current customers the incentive to opt for as short a contract term as possible so that, at contract expiration, they can reassess the value of the capacity and decide if it is in their interest to keep it. If pipeline capacity is relatively valuable, there are likely to be other shippers interested in long-term contracts, but the existing shipper will exercise its right of first refusal and retain the capacity for a five-year term. On the other hand, if the market value of long term capacity is low, the existing shipper can terminate the contract with no obligation to the pipeline. In these circumstances, there is no reason for a shipper with a right of first refusal to enter into a long-term contract because it can use a series of short-term contracts to obtain long-term service, and wait and see how the market develops.

This results in an imbalance of risks between pipelines and existing shippers. The pipeline is obligated to provide service for the shipper indefinitely, as long as it exercises its right of first refusal, while the shipper has no corresponding long-term obligation to the pipeline. Elimination of the five-year cap from the right of first refusal would remove a significant factor in the risk asymmetry discussed above. Without a limitation on the contract length that must be matched by the existing shipper, an existing shipper who wants to be assured of access to capacity for the long term would have to match the highest rate bid up to the maximum cost-based, for the capacity for the duration of the contract bid, and thus share with the pipeline some of the risks associated with the long-term commitment.

Elimination of the cap limiting the contract length that the existing shipper must match also would foster efficient competition, as encouraged by Order No. 636. This cap tends to protect existing shippers from competition and give them control over pipeline capacity. Without the cap, the term of a contract will be determined by market forces, rather than by the limitation established by the Commission.

In *UDC* v. *FERC*,[122] the Court stated that for a finding of public convenience and necessity for pre-granted abandonment, the Commission must make appropriate findings that existing market conditions and regulatory structures protect customers from pipelines' market power. The Court found that the right of first refusal mechanism with a cap on contract length was one adequate means of protecting customers from pipeline market power. In response to the Court's concern that the Commission had failed to justify a twenty-year cap, the Commission adopted the five-year cap in Order No. 636–C. However, conditions in the market have changed substantially since the issuance of Order No. 636, and the five-year cap has not worked well in the restructured market. As discussed above, it has led to asymmetry of risk and a bias toward short-term contracts. Therefore, the Commission is proposing to eliminate the term matching cap from the right of first refusal and is seeking comments on this proposal.[123]

The Commission is also considering whether, in view of the changed market conditions, the right of first refusal should be eliminated entirely. Since restructuring, increased competition in both the commodity and capacity markets now affords customers greater protections from market power. Small LDCs no longer have to hold capacity on the pipeline in order to receive gas, and can buy gas delivered from marketers or can obtain capacity in the secondary market. In fact, many LDCs have chosen not to hold capacity on pipelines. Therefore, changed conditions suggest that the right of first refusal may no longer be needed to protect the customers it was originally intended to protect. The Commission is seeking comments on eliminating the right of first refusal, as well as other options, such as changing the length of the term matching cap or permitting the pipelines and the customers to negotiate for a right of first refusal.

2. Term-Differentiated Maximum Rates

Another method of reducing risk asymmetry and strengthening the long-term market would be to encourage contracts that contain lower maximum rates for longer-term service than for short-term service in recognition of the value of long-term contracts in limiting the pipeline's risk. As explained above, a short-term contract is riskier for the pipeline, and a higher short-term contract rate would compensate pipelines for the additional risk they take when entering short-term contracts. Conversely, a short-term contract provides greater flexibility and less risk to the shipper, and the higher short-term rate would recognize, and require payment for, these benefits.

The Commission is seeking comments on whether and how term-differentiated maximum rates should be encouraged, and, if so, how the rate differential should vary with contract term. For example, should there be only two contract length categories, or should there be more? How would the appropriate contract length categories be determined? How should the rate differentials between term categories be set? Could a market mechanism be developed for determining the appropriate differentials?

Negotiation may be a primary way of addressing the sharing of risk between the parties, to ensure that parties can contract to minimize the total cost of that risk. Negotiation of rates and services is a possible solution to some of the problems discussed above. The limitations discussed in the preceding section[124] should keep negotiations from hurting the fungibility of the capacity in the short-term market, increasing the pipelines' (or their affiliates'') ability to exercise market power, and otherwise hurting third parties.

C. New Capacity Certificate Issues

The Commission's proposed changes in the short-term market also create a need to review its policies for

[120] 18 CFR 284.221(d).

[121] Order No. 636 capped the matching term at 20 years.

[122] 88 F.3d 1105, 1139 (D.C. Cir. 1996), *cert. denied*, 117 S. Ct. 1723 (1997).

[123] The term matching cap is not set forth in the regulations, and, therefore, no revision to 18 CFR 284.221(d) is necessary.

[124] The proceding section of this NOPR discusses the role of negotiated terms and conditions in the short-term market.

certificating new capacity and services. As explained above, the removal of the price cap in the short-term market requires that viable regulated services be available in the long-term market to mitigate any market power of capacity sellers. The Commission's certificate policies are critical to assuring that pipelines construct the optimal amount of capacity to meet demand in the long-term market. Therefore, the Commission is reviewing its certificate policies to determine whether these policies should be modified to meet current market conditions and needs, particularly in light of the proposed changes in the short-term market.

The Commission's objective in this review is to assure that its policy is well-balanced so that facilities are constructed where demand warrants construction, while at the same time guarding against additional construction that is not necessary to meet any increase in demand for capacity and that could result in excess capacity and the problems of unsubscribed capacity. The Commission also seeks to assure that its policies will not result in building new capacity in markets where existing facilities are not fully subscribed because this could create false price signals and weaken the long-term transportation market.[125]

Under the policy set forth in *Kansas Pipe Line & Gas Company (Kansas Pipe Line),*[126] the Commission required an applicant seeking an NGA section 7 certificate for authority to construct and operate new facilities to show customer commitments sufficient to justify the proposed project. In order to demonstrate the need for a new project, an applicant was required to submit market studies of the customers and area to be served, and contracts showing long-term commitments for 100 percent of the proposed facility's capacity. This approach made it unlikely that too much capacity would be built.

Under the current policy, an applicant for a traditional section 7 certificate must submit precedent agreements for long-term firm service[127] for a substantial amount of the new facility's capacity.[128] Where an applicant is not able to provide evidence of long-term commitments for firm service for at least 25 percent of a proposed facility's capacity, the Commission will typically place the applicant at risk for unrecovered costs attributable to the unsubscribed capacity.[129] This at-risk condition is intended to discourage overbuilding and assure that the pipeline's other customers are not compelled to pay for costs associated with unused capacity.

In considering evidence of market demand, the Commission gives equal weight to precedent agreements between an applicant and its affiliates and an applicant and unrelated third parties. Further, the Commission has not sought to assess whether these customer commitments indicate a genuine growth in market demand necessitating additional gas supplies, or reflect a desire to access separate supply sources for unchanging quantities of gas, or represent efforts to obtain reduced transportation charges for shipping identical gas volumes. Before Order No. 636, new projects were typically intended to bring gas to unserved or clearly under-served markets. Increasingly, new projects are designed to compete for market share by offering alternatives to customers in established markets.

The Commission seeks to assure that its policies strike the proper balance between the enhancement of competitive alternatives and the possibility of over building. The Commission wants to assure that its policies serve to maximize competitive alternatives, while at the same time protect against overbuilding, unnecessary disruption of the environment, and unneeded exercise of eminent domain over private property. Specifically, the Commission seeks comments on whether proposed projects that will establish a new right-of-way in order to compete for existing market share should be subject to the same considerations as projects that will cut a new right-of-way in order to extend gas service to a frontier market area. In conjunction with this reassessment of project need, the Commission is considering how best to balance demonstrated market demand against potential adverse environmental impacts and private property rights in weighing whether a project is required by the public convenience and necessity.[130]

One option would be for the Commission to authorize all applications that at a minimum meet the regulatory requirements, then let the market pick winners and losers. Another would be for the Commission to select a single project to serve a given market and exclude all other competitors. Another possible option would be for the Commission to approve an environmentally acceptable right-of-way and let potential builders compete for a certificate.

The Commission requests comments on these three options, as well as comments on the following questions: (1) Should the Commission look behind the precedent agreement or contracts presented as evidence of market demand to assess independently the market's need for additional gas service? (2) Should the Commission apply a different standard to precedent agreements or contracts with affiliates than with non-affiliates? For example, should a proposal supported by affiliate agreements have to show a higher percentage of contracted-for capacity than a proposal supported by non-affiliate agreements, or, should all proposed projects be required to show a minimum percent of non-affiliate support? (3) Are precedent agreements primarily with affiliates sufficient to meet the statutory requirement that construction must be required by the public convenience and necessity, and, if so, (4) Should the Commission permit rolled-in rate treatment for facilities built to serve a pipeline affiliate?[131] (5) Should the Commission, in an effort to check overbuilding and capacity turnback, take a harder look at proposals that are designed to compete for existing market share rather than bring service to a new customer base, and what particular criteria should be applied in

[125] In the NOI, the Commission discusses price distortions in the California and Chicago markets, where several pipelines were facing significant turnback of long-term capacity, while other pipelines were constructing additional capacity to serve those markets.

[126] 2 FPC 29 (1939).

[127] For purposes of evaluating applications for new construction, a long term is a term of at least 10 years. *See e.g.,* Texas Eastern Transmission Corp., 82 FERC ¶61,238 (March 11, 1998).

[128] ''Generally, as it has evolved, the minimum level of firm commitment that the Commission has determined to be sufficient for a new onshore facility has been 25 percent of the proposed project's capacity.'' *Id.* at 61,916.

[129] *But see* 18 CFR 157.100–157.106 (Applicants for an optional expedited certificate under Subpart E of Part 157 may receive a certificate to construct for others for new service without any requirement to show specific market demand; however, the rates for service provided through such facilities will be designed to impose the economic risks of the project entirely on the applicant).

[130] *See, e.g.,* Granite State Gas Transmission, 83 FERC ¶61,194 (1998). The Commission authorized a new liquefied natural gas (LNG) facility after comparing services to be provided by the proposed facility with similar services that might be offered by employing alternative facilities. Although employing existing facilities could result in diminished adverse environmental impacts, the Commission authorized the proposed project, finding the service made available by the new LNG facility would provide specific advantages over the alternatives.

[131] As discussed in the NOI, in the Pricing Policy for New and Existing Facilities Constructed by Interstate Natural Gas Pipelines, 71 FERC ¶61,241 (1995), the Commission adopted a presumption in favor of rolled-in rates when the rate increase to existing customers from rolling in the new facilities in 5 percent or less, and the pipeline makes a showing of system benefits.

looking at competitive applications versus new market applications? (6) Should the Commission encourage pre-filing resolution of landowner issues by subjecting proposed projects to a diminished degree of scrutiny where the project sponsor is able to demonstrate it has obtained all necessary right-of-way authority? (7) Should a different standard be applied to project sponsors who do not plan to use either federal or state-granted rights of eminent domain to acquire right-of-way?

The parties may also address other questions concerning certification issues in general, including: (1) What should the Commission do to provide for the infrastructure to serve future increased demand for capacity? (2) How can pipelines deal with the potential for not recovering new construction costs? Should the Commission address, at the certificate issuance stage, the issue of a pipeline's responsibility for future cost under-recovery once its initial contracts expire? Assuming no adverse environmental impacts, should a pipeline be allowed to build if it does not accept the responsibility for all of the cost not covered by its initial contracts? What, if anything, should the Commission do to ensure rate certainty for customers and pipelines? Can or should this include guarantees against future rolling-in of costly expansions, future changes in O&M expenses, or any other future changes? (3) Should the Commission reassess the balance between risk and return? Is there really more risk for a pipeline with short-term contracts, or will shippers continue to make short-term deals for the life of the pipeline that cover the pipeline's cost-of-service? Is any of the risk unnecessary, and can it be eliminated without imposing additional costs? How should rates be determined after contracts expire? Should the Commission establish different pricing based on contract term? (4) What are the advantages (or disadvantages) of allowing pipelines and customers to negotiate pre-construction risk and return-sharing agreements, and what actions should the Commission take if pipelines and customers do not agree on the allocation of risk and return? (5) To what extent should the policies on new construction and existing pipelines match? (6) How does retail unbundling and open access affect all of these issues?

VII. Reorganization of Part 284 Regulations

Commission proposes to reorganize certain portions of its Part 284 regulations to better reflect the nature of services in the short-term market and to consolidate its Part 284 reporting and filing requirements in a single section. Because capacity release has become an integral part of the short-term market, the Commission is proposing to move its capacity release regulations from subpart H of Part 284 to the same location in its regulations as pipeline firm and interruptible service (newly designated sections 284.7 (firm service), 284.8 (release of firm service), and 284.9 (interruptible service)).

In addition, reporting and filing requirements for pipeline Part 284 services are presently scattered throughout Part 284. For example, the Index of Customers and storage reports are presently located in subpart B, section 284.106, which deals with interstate pipelines performing transportation service under the Natural Gas Policy Act (NGPA). But these regulations are then applied to interstate pipelines performing open access services in subpart G, section 284.223. Other reporting requirements are located throughout various substantive provisions of Part 284.[132] The Commission is proposing to collect these requirements into one new section (proposed § 284.14) applicable to interstate pipelines transporting gas under Subpart B (transportation under section 311 of the NGPA) and Subpart G (open access transportation under the NGA). Reporting requirements specific to Subpart B pipelines (by-pass reports) remain in Subpart B.

To aid commenters' review of the new regulatory format, the following would be the new outline for subpart A of Part 284.

284.1 Definitions.
284.2 Refunds and interest.
284.3 Jurisdiction under the Natural Gas Act.
284.4 Reporting.
284.5 Further terms and conditions.
284.6 Rate interpretations.
284.7 Firm transportation service.
284.8 Release of firm transportation service.
284.9 Interruptible transportation service.
284.10 Rates.
284.11 Negotiated rates and services.
284.12 Environmental compliance.
284.13 Standards for pipeline business operations and communications.
284.14 Reporting requirements for interstate pipelines.

The Commission recognizes that such changes may occasion the need for cross-reference changes in other sections of Part 284 as well as other parts of the regulations. The Commission would make such non-substantive changes in the final rule, and commenters should point out regulatory sections where such changes are needed.

VIII. Information Collection Statement

The following collections of information would be affected by this proposed rule and have been submitted to the Office of Management and Budget (OMB) for review under Section 3507(d) of the Paperwork Reduction Act of 1995, 44 U.S.C. 3507(d). The Commission solicits comments on the Commission's need for this information, whether the information will have practical utility, the accuracy of the provided burden estimates, ways to enhance the quality, utility, and clarity of the information to be collected, and any suggested methods for minimizing respondents's burden, including the use of automated information techniques. The burden estimate in this proposed rule includes the cost for pipelines to comply with the Commission's proposed regulations concerning short-term natural gas transportation services. The following burden estimates reflect only the incremental costs of complying with the proposed new and revised standards intended to implement the Commission's regulations. The burden estimates include start up and on-going costs.

Estimated Annual Burden: The estimated annual burden associated with this NOPR is shown below.

Affected data collection	Number of respondents	Number of responses per respondent	Estimated burden hours per response	Total annual burden hours
FERC–545	100	2.0	97.800	19,560
FERC–549B	100	446.5	1.526	68,136
FERC–592	74	1.0	7.000	518
Total				88,214

[132] *See*, e.g., 18 CFR 284.8 (b) (3) and 284.9 (b) (3) (requirements to provide information on available capacity); 284.7 (c) (6) (discount reports); 18 CFR 284.12 (filing of capacity).

The estimated number of reporting hours attributable to the requirements proposed herein are expected to total 88,214 hours and are included in the above annual burden estimates.

Information Collection Costs: The Commission seeks comments on the estimated cost to comply with these requirements. It has projected average annualized costs for all respondents to be the following:

[In dollars]

Estimated data collection costs	FERC–545	FERC–549B	FERC–592	Total
Annualized Capital/Startup Costs	842,061	168,412	0	1,010,473
Annualized Costs (Operations & Maintenance)	187,359	3,417,506	27,262	3,632,127
Total Annualized Costs	$1,029,420	3,585,918	27,262	4,642,600

The OMB regulations require OMB to approve certain information collection requirements imposed by agency rule.[133] Accordingly, pursuant to OMB regulations, the Commission is providing notice of its proposed information collections to OMB.

Titles: FERC–545, Gas Pipeline Rates: Rate Change (Non-Formal); FERC–549B, Gas Pipeline Rates: Capacity Information (a proposed new title); and FERC–592, Marketing Affiliates of Interstate Pipelines.

Action: Proposed Data Collections.

OMB Control Numbers: 1902–0154; 1902–0169; and 1902–0157, respectively. The respondent shall not be penalized for failure to respond to these information collections unless the collection of information displays a valid OMB control number.

Respondents: Business or other for profit, including small businesses.

Frequency of Responses: On occasion.

Necessity of Information: The proposed rule seeks to establish reporting requirements that will provide information needed for the market to operate more efficiently and for shippers and the Commission to effectively monitor transactions for undue discrimination and the exercise of market power.

Internal Review: The Commission has assured itself, by means of its internal review, that there is specific, objective support for the burden estimates associated with the information collection requirements. The Commission's Office of Pipeline Regulation will use the data to monitor the market place to correct problems and minimize the exercise of market power. Additionally, the industry itself will use the information to make more informed choices from among alternative capacity sources and to monitor the marketplace. The Commission's determination of burden involves among other things, an examination of adequacy of design, cost, reliability, and redundancy of the information to be required. These requirements conform to the Commission's plan for efficient information collection, communication, and management within the natural gas pipeline industry.

Interested persons may obtain information on the reporting requirements by contacting the following: Federal Energy Regulatory Commission, 888 First Street, NE, Washington, DC 20426, [Attention: Michael Miller, Office of the Chief Information Officer, Phone: (202)208–1415, fax: (202)273–0873, e-mail: michael.miller@ferc.fed.us]

For submitting comments concerning the collections of information(s) and the associated burden estimate(s), please send your comments to the contact listed above and to the Office of Management and Budget, Office of Information and Regulatory Affairs, Washington, DC, 20503. [Attention: Desk Officer for the Federal Energy Regulatory Commission, phone: (202)395–3087, fax: (202)395–7285.

IX. Environmental Analysis

The Commission is required to prepare an Environmental Assessment or an Environmental Impact Statement for any action that may have a significant adverse effect on the human environment.[134] The Commission has categorically excluded certain actions from these requirements as not having a significant effect on the human environment.[135] The actions proposed to be taken here fall within categorical exclusions in the Commission's regulations for rules that are clarifying, corrective, or procedural, for information gathering, analysis, and dissemination, and for sales, exchange, and transportation of natural gas that requires no construction of facilities.[136] Therefore, an environmental assessment is unnecessary and has not been prepared in this rulemaking.

X. Regulatory Flexibility Act Certification

The Regulatory Flexibility Act of 1980 (RFA) [137] generally requires a description and analysis of final rules that will have significant economic impact on a substantial number of small entities. The proposed regulations would impose requirements on interstate pipelines, which generally are not small businesses. Accordingly, pursuant to section 605(b) of the RFA, the Commission proposes to certify that the regulations proposed herein will not have a significant adverse impact on a substantial number of small entities.

XI. Comment Procedures

The Commission invites interested persons to submit written comments on the matters and issues proposed in this notice to be adopted, including any related matters or alternative proposals that commenters may wish to discuss. An original and 14 copies of comments must be filed with the Commission no later than November 9, 1998. Comments should be submitted to the Office of the Secretary, Federal Energy Regulatory Commission, 888 First Street, NE, Washington, DC 20426, and should refer to Docket No. RM98–10–000. All written comments will be placed in the Commission's public files and will be available for inspection in the Commission's Public Reference Room at 888 First Street, NE, Washington, DC 20426, during regular business hours.

Additionally, comments should be submitted electronically. Commenters are encouraged to file comments using Internet E-Mail. Comments should be submitted through the Internet by E-Mail to comment.rm@ferc.fed.us in the

[133] 5 CFR 1320.11.

[134] Order No. 486, Regulations Implementing the National Environmental Policy Act, 52 FR 47897 (Dec. 17, 1987), FERC Stats, & Regs. Preambles 1986–1990 ¶30,783 (1987).

[135] 18 CFR 380.4.

[136] *See* 18 CFR 380.4(a)(2)(ii), 380.4(a)(5), 380.4(a)(27).

[137] 5 U.S.C. 601–612.

following format: on the subject line, specify Docket No. RM98–10–000; in the body of the E-Mail message, specify the name of the filing entity and the name, telephone number and E-Mail address of a contact person; and attach the comment in WordPerfect® 6.1 or lower format or in ASCII format as an attachment to the E-Mail message. The Commission will send a reply to the E-Mail to acknowledge receipt. Questions or comments on electronic filing using Internet E-Mail should be directed to Marvin Rosenberg at 202–208–1283, E-Mail address marvin.rosenberg@ferc.fed.us.

Commenters also can submit comments on computer diskette in WordPerfect® 6.1 or lower format or in ASCII format, with the name of the filer and Docket No. RM98–10–000 on the outside of the diskette.

List of Subjects

18 CFR Part 161

Natural gas, Reporting and recordkeeping requirements.

18 CFR Part 250

Natural gas, Reporting and recordkeeping requirements.

CFR Part 284

Continental shelf, Incorporation by reference, Natural gas, Reporting and recordkeeping requirements.

By direction of the Commission.

David P. Boergers,

Acting Secretary.

In consideration of the foregoing, the Commission proposes to amend part 161, part 250, and part 284, chapter I, title 18, Code of Federal Regulations, as set forth below.

PART 161—STANDARDS OF CONDUCT FOR INTERSTATE PIPELINES WITH MARKETING AFFILIATES

1. The authority citation for Part 161 continues to read as follows:

Authority: 15 U.S.C. 717–717w, 3301–3432; 42 U.S.C. 7101–7352.

2. In § 161.3, paragraphs (i) through (k) are renumbered (j) through (l) and paragraph (i) is added to read as follows:

§ 161.3 Standards of conduct

* * * * *

(i) A pipeline must post the following information concerning its affiliates on its Internet web site complying with § 284.13 of this chapter and update the information within three business days of any change, posting the date on which the information was updated.

(1) A complete list of operating personnel and facilities shared by the pipeline and its marketing affiliates.

(2) Comprehensive organizational charts and job descriptions for its employees and the employees of its marketing affiliates identifying which employees are engaged in transportation and which are engaged in sales or marketing, and clearly showing the chain of command. The job descriptions need not include employees whose jobs are purely clerical or those without responsibility or access to information concerning the processing or administration of requests for transportation service. Each job description must include: the employee's title, duties and status as an operating or non-operating employee; and in the case of a senior employee (*i.e.*, any employee who supervises non-clerical employees), the employee's name.

* * * * *

3. In § 161.3(h)(2), revise all references to ''284.10(a)'' to read ''284.13'' and remove the words ''Electronic Bulletin Board, operated pursuant to'' and add, in their place, the words ''Internet Web site complying with''.

PART 250—FORMS

4. The authority citation for part 250 continues to read as follows:

Authority: 15 U.S.C. 717–717w, 3301–3432; 42 U.S.C. 7101–7352.

5. In § 250.16, paragraph (b)(1) is removed, paragraph (b)(2) is redesignated as (b)(1), and paragraph (b)(2) is reserved.

§ 250.16 [Amended]

6. In § 250.16(c)(2), revise all references to ''284.10(a)'' to read ''284.13'' and remove the words ''Electronic Bulletin Board, operated pursuant to'' and add, in their place, the words'' Internet Web site complying with''.

PART 284—CERTAIN SALES AND TRANSPORTATION OF NATURAL GAS UNDER THE NATURAL GAS POLICY ACT OF 1978 AND RELATED AUTHORITIES

7. The authority citation for part 284 continues to read as follows:

Authority: 15 U.S.C. 717–717w, 3301–3432; 42 U.S.C 7101–7532; 43 U.S.C 1331–1356.

§ 284.12 [Removed]

8(a) Part 284 is amended by removing § 284.12.

8(b) Part 284 is amended by redesignating the sections as set forth in the following redesignation table:

Old section	New section
284.7	284.10
284.8	284.7
284.10	284.13
284.11	284.12

9. In newly redesignated § 284.7, paragraph (b)(3) is removed and paragraph (b)(4) is redesignated as paragraph (b)(3).

10. Part 284 is amended by adding § 284.8 to read as follows:

§ 284.8 Release of firm transportation service.

(a) An interstate pipeline that offers transportation service on a firm basis under subparts B or G of this part must include in its tariff a mechanism for firm shippers to release firm capacity to the pipeline for resale by the pipeline on a firm basis.

(b) To the extent necessary, a firm shipper on an interstate pipeline that offers transportation service on a firm basis under subpart B or G of this part is granted a limited-jurisdiction blanket certificate of public convenience and necessity pursuant to section 7 of the Natural Gas Act solely for the purpose of releasing firm capacity pursuant to this section.

(c) The pipeline must enter into a contract with the replacement shipper purchasing the capacity. Unless otherwise agreed by the pipeline, the contract of the shipper releasing capacity will remain in full force and effect, with the net proceeds from any resale to a replacement shipper credited to the releasing shipper's reservation charge.

(d) Releases of capacity for a period of less than one year must conform to the requirements of the auction established under § 284.10(c)(5) of this part.

(e) Releases of capacity of one year or more must comply with the following requirements.

(1) A shipper may arrange for a replacement shipper to obtain its released capacity from the pipeline. The releasing and replacement shippers or an authorized agent must notify the pipeline of the terms and conditions of the release.

(2) A shipper may post any capacity it has available on the pipeline's Internet site and may authorize the pipeline to accept bids for such capacity. A releasing shipper posting capacity for bid must notify the pipeline of the terms and conditions under which it will release its capacity.

(3) For releases of capacity of one year or more, the rate may not exceed the maximum rate in the pipeline's tariff.

§ 284.9 [Amended]

11. In § 284.9, paragraph (b)(3) is removed and paragraph (b)(4) is redesignated paragraph as (b)(3).

12. In newly redesignated § 284.10, paragraphs (c)(5) and (c)(6) are revised, and paragraph (c)(7) is added to read as follows.

§ 284.10 Rates.

* * * * *

(c) * * *

(5) *Rates for short-term transportation services.* For transportation contracts of less than one year for pipeline firm and interruptible service and for capacity released pursuant to § 284.8 of this part, the rates will be determined in the following manner.

(i) *Minimum rate.* The minimum rate charged for such service may not be lower than the minimum rate in the pipeline's tariff.

(ii) *Capacity auction.* The rate charged for any transaction at or above the minimum rate will be determined by an auction that conforms to the following requirements:

(A) All available short-term capacity must be sold through an auction;

(B) Daily capacity from the pipeline must be sold through an auction without the establishment of a reserve or minimum bid price;

(C) All eligible shippers must be permitted to bid with no favoritism shown to pipeline affiliates or other shippers;

(D) The procedures and rules for each auction, including the auction schedule, must be disclosed in the pipeline's tariff in advance of the auction and must be applied to each auction;

(E) Capacity must be allocated based on established criteria and parameters known in advance to all bidders and the same criteria and parameters must apply to pipeline and released capacity;

(F) Shippers must be able to validate that the auction was run properly either through the posting of information sufficient to permit them to validate that the winners were selected appropriately or through the use of other mechanisms, such as an independent third-party, which will validate the results.

(6) *Rates for long-term transportation services.* (i) Except as provided in section (ii) of this paragraph and § 284.11 of this part, for transportation contracts of one year or longer for pipeline firm and interruptible service, the pipeline may charge an individual customer a rate that is neither greater than the maximum rate nor less than the minimum rate on file for that service.

(ii) The pipeline may not file a revised or new rate designed to recover costs not recovered under rates previously in effect.

(7) *Rates involving marketing affiliates.* If a pipeline does not hold a blanket certificate under subpart G of this part, it may not charge, in a transaction involving its marketing affiliate, a rate that is lower than the highest rate it charges in any transaction not involving its marketing affiliate.

13. Part 284 is amended by adding § 284.11 to read as follows.

§ 284.11 Negotiated rates and services.

(a) *Authority.* An interstate pipeline that provides transportation service under subparts B or G of this part may negotiate with shippers the rates, or terms and conditions of service, in any contract, provided the pipeline offers all shippers recourse to transportation service under its generally applicable transportation tariff as an alternative to negotiated service.

(b) *Limitations on negotiations.* Pipelines cannot negotiate rates and services that:

(1) result in undue discrimination or preference;

(2) degrade the quality of existing services;

(3) hinder the release of capacity or otherwise significantly reduce competition; or

(4) require customers, as a condition of obtaining negotiated rates or services, to purchase sales, storage, or gathering services provided by the pipeline, its affiliates, or upstream or downstream entities that are unnecessary to the provision of the negotiated service.

(c) *Review of recourse service.* Pipelines must file (every 3 or 5 years) the following information regarding negotiated rates and terms of service and recourse service.

(1) For each negotiated transaction, the pipeline must file, for each calendar year, by category of negotiated transaction (transactions taking effect on shortened notice and transactions subject to 30 days notice) the following: the name of the shipper, the shipper's designation (e.g., marketer, producer, LDC, end-user), the contract number, the docket number under which the contract was filed with the Commission, the type of service (e.g., firm or interruptible transportation or storage), the contract demand, the rate, and the volume. For transactions taking effect under shortened notice, the pipeline must include an indication of the tariff categories under which the contract was negotiated. For transactions subject to thirty days notice, the pipeline must include a short description of the terms and conditions negotiated.

(2) For each year, for each category of negotiated service and for recourse services, by rate schedule, the pipeline must file data showing aggregate contract demand, aggregate volumes, and aggregate revenue.

14. In newly redesignated § 284.13, paragraphs (c)(1)(ii) and (c)(2)(iii) through (v) are added and paragraph (b)(1)(v) is revised to read as follows.

§ 284.13 Standards for pipeline business operations and communications.

* * * * *

(b) * * *

(1) * * *

(v) Capacity Release Related Standards (Version 1.2,

July 31, 1997), with the exception of Standard 5.3.2.

(c) * * *

(1) * * *

(ii) *Capacity release nominations.* Pipelines must permit shippers acquiring released capacity to submit a nomination at the earliest available nomination opportunity after the acquisition of capacity. If the pipeline requires the replacement shipper to enter into a contract, the contract must be issued within one hour of submission of the transaction, but the requirement for contracting must not inhibit the ability to submit a nomination at the time the transaction is complete.

(2) * * *

(iii) *Imbalance management.* A pipeline must provide, to the extent operationally practicable, parking and lending or other services that facilitate the ability of its shippers to manage transportation imbalances. A pipeline must provide such services without undue discrimination or preference of any kind against third parties that seek to provide similar services to the shippers of the pipeline.

(iv) *Penalties.* A pipeline may include in its tariff transportation penalties only to the extent necessary for system operations. A pipeline must provide, on a timely basis, as much information as possible about the imbalance and overrun status of each shipper and the imbalance of the pipeline's system.

(v) *Operational flow orders.* A pipeline must take all reasonable actions to minimize the issuance and adverse impacts of operational flow orders (OFOs) or other measures taken to respond to adverse operational events on its system. A pipeline must set forth in its tariff clear standards for when such measures will begin and end and must provide timely information that

will enable shippers to minimize the adverse impacts of these measures.

* * * * *

15. Part 284 is amended by adding § 284.14 to read as follows:

§ 284.14 Reporting requirements for interstate pipelines.

An interstate pipeline that provides transportation service under subparts B or G of this part must comply with the following reporting requirements.

(a) *Cross references.* The pipeline must comply with the requirements in part 161, part 250, and part 260, where applicable.

(b) *Index of customers.* (1) On the first business day of each calendar quarter, subsequent to the initial implementation of this provision, an interstate pipeline must provide for electronic dissemination of an index of all its firm transportation and storage customers under contract as of the first day of the calendar quarter. Electronic dissemination will be by placing a file, adhering to the requirements set forth by the Commission, on the pipeline's Internet web site, pursuant to section 284.13 of this part, in a format which can be downloaded. The pipeline must also submit the electronic file to the Commission.

(2) Until an interstate pipeline is in compliance with the reporting requirements of this paragraph, the pipeline must comply with the index of customer requirements applicable to transportation and sales under part 157, set forth under § 154.111(b) and (c) of this chapter.

(3) For each customer receiving firm transportation or storage service, the index must include the information listed below:

(i) The full legal name of the customer;

(ii) The rate schedule number of the service being provided;

(iii) The contract number;

(iv) The contract effective date;

(v) The contract expiration date;

(vi) For transportation service, maximum daily contract quantity (specify unit of measurement);

(vii) For storage service, maximum storage quantity (specify unit of measurement);

(viii) The receipt and delivery points and the zones or segments in which the capacity is held;

(ix) An indication as to whether the contract includes negotiated rates or terms and conditions;

(x) Any affiliate relationship between the pipeline and the customer or any affiliate relationships between contract holders;

(xi) The name of any agent or asset manager managing 20% or more of the transportation service in a pipeline rate zone and the agent's and asset manager's rights with respect to managing the transportation service.

(4) The information included in the quarterly index must be available on the pipeline's web site until the next quarterly index is established.

(5) The requirements of this section do not apply to contracts which relate solely to the release of capacity under § 284.8, unless the release is permanent.

(6) The requirements for the electronic index can be obtained at the Federal Energy Regulatory Commission, Division of Information Services, Public Reference and Files Maintenance Branch, Washington, DC 20426.

(c) *Reports on firm and interruptible services.* An interstate pipeline must post the following information on its Internet web site, and provide the information in downloadable file formats, in conformity with section 284.13 of this part.

(1) For pipeline firm service, whether provided by the pipeline or from release transactions under section 284.8 of this part, the pipeline must post, contemporaneously with the execution of a contract for service:

(i) The full legal name of the shipper receiving service under the contract and the full legal name of the releasing shipper if a capacity release is involved or an indication that the pipeline is the seller of transportation capacity;

(ii) The contract number for the shipper receiving service under the contract, and, in addition, for released transactions, the contract number of the releasing shipper's contract;

(iii) The rate charged under each contract;

(iv) The duration of the contract;

(v) The receipt and delivery points and mainline segments covered by the contract;

(vi) The contract quantity or the volumetric quantity under a volumetric release;

(vii) Any special terms and conditions applicable to the contract; and

(viii) Whether there is an affiliate relationship between the pipeline and the shipper or between the releasing and replacement shipper.

(2) For pipeline interruptible service, the pipeline must post on a daily basis:

(i) The full legal name of the shipper;

(ii) The rate charged;

(iii) The receipt and delivery points and mainline segments over which the shipper is entitled to nominate gas;

(iv) The quantity of gas the shipper is entitled to nominate;

(v) Whether the shipper is affiliated with the pipeline.

(d) *Available capacity.* (1) An interstate pipeline must provide on its Internet web site and in downloadable file formats, in conformity with section 284.13 of this part, equal and timely access to information relevant to the availability of all transportation services, including, but not limited to, the availability of capacity at receipt points, on the mainline, at delivery points, and in storage fields, whether the capacity is available directly from the pipeline or through capacity release, the total design capacity of each point or segment on the system, the amount scheduled at each point or segment on a daily basis, and all planned and actual service outages or reductions in service capacity.

(2) An interstate pipeline must make an annual filing by March 1 of each year showing the estimated peak day capacity of the pipeline's system, and the estimated storage capacity and maximum daily delivery capability of storage facilities under reasonably representative operating assumptions and the respective assignments of that capacity to the various firm services provided by the pipeline.

(e) *Semi-annual storage report.* Within 30 days of the end of each complete storage injection and withdrawal season, the interstate pipeline must file with the Commission a report of storage activity. The report must be signed under oath by a senior official, consist of an original and five conformed copies, and contain a summary of storage injection and withdrawal activities to include the following:

(1) The identity of each customer injecting gas into storage and/or withdrawing gas from storage, identifying any affiliation with the interstate pipeline;

(2) The rate schedule under which the storage injection or withdrawal service was performed;

(3) The maximum storage quantity and maximum daily withdrawal quantity applicable to each storage customer;

(4) For each storage customer, the volume of gas (in dekatherms) injected into and/or withdrawn from storage during the period;

(5) The unit charge and total revenues received during the injection/withdrawal period from each storage customer, noting the extent of any discounts permitted during the period; and

(6) The related docket numbers in which the interstate pipeline reported storage related injection/withdrawal transportation services.

16. In § 284.106, paragraph (c) is removed and paragraph (b) is revised to read as follows:

§ 284.106 Reporting requirements

* * * * *

(b) An interstate pipeline providing transportation service under this subpart must comply with the reporting requirements of § 284.14 of this part.

§ 284.223 [Amended]

17. In § 284.223, paragraph (b) is removed and reserved.

18. Subpart H is revised to read as follows:

Subpart H—Assignment of Capacity on Upstream Interstate Pipelines

§ 284.241. Upstream interstate pipelines.

An interstate pipeline that offers transportation service on a firm basis under subpart B or G of this part must offer without undue discrimination to assign to its firm shippers its firm transportation capacity, including contract storage, on all upstream pipelines, whether the firm capacity is authorized under part 284 or part 157. An upstream pipeline is authorized and required to permit a downstream pipeline to assign its firm capacity to the downstream pipeline's firm shippers.

§§ 284.10, 284.123, 284.221, 284.261, 284.263, 284.266, and 284.286 [Amended]

19. §§ 284.10, 284.123, 284.221, 284.261, 284.263, 284.266, and 284.286 [Amended]

In addition to the amendments set forth above, in 18 CFR part 284, the following nomenclature changes are made:

A. Revise all references to ''§ 284.7'' to read ''§ 284.10'' in the following places:

1. Section 284.221(d)(2)(ii);
2. Section 284.261;
3. Section 284.263; and
4. Sections 284.266(a)(1) and (a)(2).

B. Revise all references to ''§§ 284.8–284.13'' to read ''§§ 284.7–284.9 and §§ 284.11–284.14'' in the following places:

1. Section 284.261; and
2. Section 284.263.

C. Revise all references to ''§ 284.8(d)'' to read ''§ 284.7(d)'' in newly redesignated §§ 284.10(c)(1) and (c)(2).

D. Revise all references to ''§§ 284.8'' to read ''§§ 284.7'' in § 284.123 (b)(1).

E. Revise all references to ''§§ 284.8(b)(2)'' to read ''§§ 284.7(b)(2)'' in § 284.286(b).

F. Remove the words ''§§ 161.3(c), (e), (f), (g), and (h)'' and add, in its place, the words ''§§ 161.3(c), (e), (f), (g), (h), and (i)'' in section 284.286(c).

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