FERC Order 436—An Overview

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A layman explains the Federal Energy Regulatory Commission's order and its possible ramifications.

Introduction

FERC Order 436 is an extremely visible document. Tons of paper have been written about it. Thousands of people have sat in long meetings discussing it. It has caused considerable anguish in individual companies as those companies attempted to formulate an approach to deal with its existence.

Because of this widespread publicity, there is some vagueness on the part of people who have not dealt with it directly as to what the order is and what possible effects it will have. The purpose of this paper is to describe the order and its possible ramifications.

This paper is not written from a legal or regulatory standpoint. It is written from a layman's viewpoint. Because of this, the fine points of the rule are not unduly dwelt on, and broad interpretations are sometimes used.

For many years, the Federal Energy Regulatory Commission (FERC) and its predecessor, the Federal Power Commission, had visions of using the interstate pipelines to create a cohesive, nationwide transportation system. The individual pipeline companies, however, were not agreeable to this.

Prior to 1970, the individual pipeline companies worked to create sales on their own system, and there was a relatively small amount of transportation. When the gas shortage occurred in the early 1970's, practically every pipeline system imposed curtailments on their customers. Each pipeline could sell all the gas it could obtain on its own system, so there was no incentive to ask another pipeline to transport gas for it.

In 1978, Congress passed the Natural Gas Policy Act which partially decontrolled natural gas. As a result, the price of gas increased and drilling increased. As more gas was found, the natural gas shortage vanished and the market became satisfied, then saturated, then glutted. With this excess supply of natural gas, a new problem arose.

During the period of natural gas shortage, pipeline companies used various incentives to purchase new long-term gas supplies. One of these incentives was the "take-or-pay" provision. Under this provision, a pipeline company, when purchasing new gas, agreed to take gas at a relatively high rate, sometimes as high as 75% of deliverability. If the gas was not taken, the pipeline company agreed to pay for it anyway. This provision guaranteed that the producer would recover his cost in a fixed time. With the gas shortage, the pipeline company felt that it was a safe provision.

By 1980, three events had occurred. First, a large number of industrial customers had switched from natural gas to coal, oil, or nuclear fuels. Second, a large conservation effort had occurred on the part of sales customers. Third, additional drilling made increased quantities of natural gas available. As a result of these three events, pipeline companies had more gas than they could market. By 1982–1983, practically all pipeline companies had take-or-pay obligations that were greater than their sales.

Faced with this situation, most pipeline companies were quite reluctant to transport gas for other companies in that it posed a threat to their existing sales. Any sale they lost hurt them in two ways—first in the revenue lost and second in the increased take-or-pay exposure.

With this series of events, the FERC had little success in promoting the widespread transportation of gas. In 1984, however, an event occurred which began to change the viewpoint of pipeline companies in regard to transportation. This event was the development of the natural gas spot market.

In late 1984, several innovative pipeline companies realized that a stalemate had been reached due to the high cost of gas supplies that were locked-in by long-term contracts. They began a four-part cooperative program which consisted of the following steps:

1. The pipeline company would select a cooperative producer and release that producer from his contract for a short period, typically 1 to 2 years.
2. The producer would contract with a customer to sell gas at reduced price for a short-term period.
3. The customer would contract with the pipeline company to transport the gas.
4. The pipeline company would receive take-or-pay credit for any gas the producer moved in this manner.

This approach gave all three parties something of value. The customer had a lower cost fuel source and a natural gas sale was made that otherwise might have gone to oil or coal. The producer had some cash flow without jeopardizing the cost of gas in long-term contracts. The pipeline company received the transportation fee. The success of this approach can be measured by the large quantities of natural gas that entered the spot market. It can also be measured by the marked decrease in the price of natural gas on the spot market. Delivered prices dropped from above \$3.00 per MMBTU to below \$1.50 in some cases. In other cases, gas would pass through as many as four pipeline companies in getting from the wellhead to the customer.

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At this time, the environment for a widespread transportation system was the most favorable that it had been for the last 40 years. It was under these conditions that the FERC revived its efforts in this direction. The first visible sign of this effort appeared in May, 1985.

On May 30, 1985, the FERC issued its notice of proposed rulemaking as Docket RM85-1. The notice proposed rules in four areas:

Part A—Transportation
Part B—Take or Pay
Part C—Optional Expedited Certificates
Part D—Billing Mechanism for Purchased Gas Costs

The key to this entire proposed program is that it is voluntary. Any individual pipeline company may elect as to whether it participates in the program. If it elects to do so, the proposed rulemaking provides some advantages and some disadvantages. Similarly, if the individual pipeline company elects not to participate, there are some advantages and disadvantages. The details of the proposal are discussed below.

Part A—Transportation

- *Transportation Must be Nondiscriminatory*—This does not mean that a participating pipeline is obligated to offer transportation to anyone who asks for it. Each participating company would be allowed to set up certain criteria for accepting transport gas. These might include minimum tender volumes, quality standards, restricted receipt, and delivery areas, etc. It does mean, however, that once the criteria are established, they must be applied in a nondiscriminatory fashion on a "first come, first served" basis to anyone wanting to have gas transported.
- *Transportation Tariffs Must Be:*
  - * *Cost of service rates.* The maximum transport fees must be based on the cost of the participating pipeline to perform the service. Rates higher than these rates could not be charged. The rates would have to be filed and approved by the FERC.
  - * *Volumetric.* In making rates, pipeline companies often use two-part rates for large customers. The first part is a demand charge, which is a payment by the customer for having the facilities available. This demand charge is a constant amount per month or per year, and is paid regardless of how much gas is used by the customer. The second part of the rate is a commodity charge, and is a per MCF or per MMBTU charge. Under the proposed rulemaking, the participating pipeline would only be allowed to make a commodity charge. This puts the pipeline at risk for any new facilities required, because if no gas flows through the facility, the pipeline collects no revenue.
  - * *Downwardly flexible.* Although the participating pipeline cannot charge more than its cost of service, it can charge less.
  - * *Differentiated by time of use.* Many pipeline companies have different amounts of spare capacity available depending on the time of year. In winter, capacity is at a premium. In summer, considerable capacity may be available. The participating pipeline could tailor its rate structure to take this into account.
- *Firm Sales Customers May Reduce Their Contract Demands*—This is one of the most crucial parts of the program. The proposed rulemaking provides that if a pipeline company participates in the program, it must give all of its firm sales customers the opportunity to decrease their contract demand by a minimum of 25% per year. Thus, in 4 years, a pipeline company could lose all of its firm sales.

  From the FERC viewpoint, this provision is necessary in order to achieve their goal in a reasonable time frame. Many firm sales contracts are long-term contracts. Without this provision, the sales customers would be locked-in to their supplier pipeline and could not take advantage of the transportation opportunities. From the pipeline company viewpoint, this provision puts them at risk of losing their firm sales customers if they are not competitive.

Part B—Take or Pay

- *A Rebuttal Presumption of Prudence Will Be Established for Certain Payments Made by Pipelines to Extinguish All Future Take-or-Pay Exposure*—The FERC felt that each pipeline company must resolve its take or pay exposure in order to enter as a participant in the transportation program. This is their attempt to assist in that effort. This provision allows each pipeline company to deal with its producers and make "certain" payments. The FERC would then automatically assume that these payments were prudent, and allow the payments to go into the rate computation. Other parties, however, could challenge or rebut these payments.

Part C—Optional Expedited Certificates

- *Expedited Certificate Procedures Will be Made Available*—The FERC promises to make available expedited procedures to speed up certification of new facilities. This provision still allows the conventional 7(c) type of certification procedure, but the implication is that the conventional procedures will be put on the back burner and may take considerably longer than at present.
- *Pipelines Must Agree to the Risk of Building These New Facilities*—Pipeline companies building new facilities under this provision will not be allowed to charge their sales customers rates

which would help pay for these facilities.

- *Pre-Granted Abandonment Will be Made*—When the term of the transport agreement ends, the pipeline may automatically stop service. An exception to this is a customer who does not have an alternate supplier.
- *Competing Certificates Will Be Issued*—Since each participating pipeline company will be building facilities at its own risk, the FERC would be willing to grant certificates to more than one pipeline to serve the same customer.

Part D—Billing Mechanism for Purchased Gas Costs

- *Gas Would Be Separated into "Old Gas" and "New Gas"*—Gas under NGPA categories 104, 106(A), and 109 would be classified as old gas and would be put in Block 1. All other gas would go into Block 2.
- *Old Gas Could Be Sold Only to Existing Firm Sales Customers*
- *Existing Firm Sales Customers Would Be Allocated Block 1 Gas Based on Their Usage for 1982, 1983, and 1984*
- *A Third Block Would Contain Non-Gas Costs*—This block might contain take-or-pay settlements or other costs not related to a per MCF basis. No method is given for the allocation of the Block 3 costs.

Under this Part D, an existing firm sales customer might receive a bill consisting of three parts. One part would be for the old gas allocated, the second would be for the Block 2 gas to make up the remainder of their usage, and the third part would be for the allocated portion of Block 3 costs. Only Block 2 gas could be used to seek new customers.

The FERC asked for comments on the proposed rulemaking, and it received them. Pipeline companies, producers, trade associations, customers, and other interested parties responded voluminously. Several hundred persons sent comments. Hearings were held on August 1–2, 1985, and over 100 commentors presented oral testimony. Following study of the written and oral comments, the FERC on October 9, 1985 issued the final rule, designated as Order 436. Although the general context of the proposed rulemaking was preserved in the final rule, certain significant changes were made.

Part A—Transportation

- *A Reservation Charge is Allowed*—Although the proposed rulemaking contemplated only volumetric rates, the FERC recognized that there could be cases where customers desired firm guaranteed transportation service and were willing to pay a reservation charge for it.
- *Changes Schedules for Firm Sales Customers to Decrease Their Contract Demand*—The proposed rulemaking provided for a minimum reduction of 25% per year, for a 4-year period to go to zero demand. The final rule changed this to a 5-year schedule with minimum reductions of 15% the first 2 years, 20% the third year, and 25% for the fourth and fifth years.

Part B—Take or Pay

- *Deletes the Safe Harbor Rule*—The presumption of prudence for payments to extinguish future take-or-pay claims was dropped.
- *Policy Reverts to FERC Policy Statement Dated April 16, 1985*—This policy puts the burden of prudence on the pipeline company in its negotiations with producers.

Part C—Optional Expedited Certificates

- *Essentially No Change*

Part D—Billing Mechanism for Purchased Gas Costs

- *Deleted from Final Rule*
- *Issued Further Notice of Proposed Rulemaking*
  - * Two blocks instead of three
  - * Non-gas costs allocated to Blocks 1 and 2
  - * Allocation period of Block 1 gas extended to cover the period December 1, 1978 to December 31, 1984.

The large majority of the major interstate pipelines have elected to participate in the FERC Order 436 transportation. These companies have filed or are preparing to file tariffs which specify the terms and conditions under which they will transport gas.

In the last 18 months, the natural gas business has become extremely competitive, and the spot market is an example. Market prices are no longer set by the FERC and by the pipeline cost of service. Market prices are set by the customers and the producers. Gas which is not competitive will not sell in the spot market. To a lesser extent, firm gas sales are also reflecting this trend.

With FERC Order 436, this trend will be accelerated. Competition between pipeline companies will intensify. Inefficient pipeline companies will have severely reduced firm gas sales and will be relegated to transporting gas in those areas where they have a unique geographic advantage. Inefficient companies which do not have a unique geographic advantage could very well perish. Pipeline companies which have strategic advantages such as geographic location, low cost gas supplies, etc., could be the target for takeovers, both friendly and hostile. Conversely, mergers and acquisitions which do little more than increase the debt load of the acquiring company could put the resulting corporation at a competitive disadvantage. The situation might be similar to that faced by the airline companies when that industry was deregulated and opened up to competition.

From a highly objective viewpoint, FERC Order 436 is extremely interesting. It is also quite beneficial to the consuming customer, at least in the short-term. Pipeline companies will be placed in a similar competitive environment to that occupied by the bulk of commodity retailers and wholesalers. They will face the same pressures as Safeway, Chrysler, and NBC. This will require different types of people and emphasis on different skills. It will be interesting to see the form, content, and texture of the pipeline industry in 1992. IRWA