

policy, pipelines must permit shippers to opt for use of a traditional cost of service "recourse" rate instead of requiring them to negotiate for rates for any particular service.⁴ The Commission determined that the availability of a recourse rate would prevent pipelines from exercising market power by assuring that the customer can fall back to cost-based, traditional service if the pipeline unilaterally demands excessive prices or withholds service.⁵

3. On July 17, 2002, in Docket No. PL02-6-000, the Commission issued a Notice of Inquiry (NOI) concerning its Negotiated Rate Policy.⁶ There, the Commission stated that it was undertaking a review of issues related to its negotiated rate program and requested comments from, and posed questions to, the gas industry regarding the Commission's negotiated rate policies and practices. The Commission has received responses from all segments of the gas industry that raise a variety of issues related to the Commission's negotiated rate policies.⁷ As discussed below, upon consideration of its experience with the existing negotiated rate program, and the comments received from the industry in the NOI proceeding, the Commission has determined to modify several aspects of its Negotiated Rate Policy.

Discussion

4. The Commission finds that its negotiated rate program has been generally successful in providing flexible, efficient pricing of pipeline capacity while mitigating pipeline use of market power by means of a recourse rate. This view is supported by the majority of commenters as they support the negotiated rates program and want it to continue. However, certain commenters suggest various changes to increase transparency of the negotiated rates and methodologies for limiting pricing options for negotiated rates. The Commission has reviewed these comments and has determined to revise its filing requirements to increase the transparency of negotiated rates in order to minimize the potential for discrimination. In addition, the

Commission has determined to address the pricing mechanisms permitted under negotiated rates in order to ensure adequate mitigation of any pipeline market power. The Commission will begin its discussion with a consideration of the use of natural gas based index prices; in particular, the use of such indices to determine basis differentials, as a pricing methodology for the negotiation of rates.

Gas Index Pricing Mechanisms

5. In its Policy Statement, the Commission set forth a mechanism by which a pipeline that does not attempt to establish a lack of market power to justify market-based rates and does not wish to embark on an incentive rate program, may seek a negotiated rate alternative to traditional cost of service ratemaking and thus achieve flexible, efficient pricing. The Commission determined that, under this policy, the availability of a cost of service based recourse rate would protect shippers from the exercise of any market power by the transporters. As such, in its efforts to permit parties to establish flexible, efficient pricing for transportation service, the Commission did not seek to limit mechanisms used in transportation price negotiations.

6. Since the establishment of this policy, pipelines have availed themselves of the flexibility of the Commission's policies to negotiate many different types of pricing mechanisms. These have included negotiated rates for transportation based upon gas commodity price indices. These gas commodity price indices, when used as a negotiated pricing mechanism, usually reflect gas prices at different points such as at natural gas production basins or certain receipt and delivery points and citygates. This transportation pricing mechanism is based upon the difference between the gas price indices at the two points that is commonly referred to as the basis differential. The foundation for this pricing mechanism is that the difference in price between two points, as shown by the respective price indices, reflects the value of transportation between the two points.

7. Several commenters oppose the use of basis differentials as a pricing mechanism for negotiated transportation rates.⁸ Those opposed to the use of such pricing mechanisms argue that the use of such basis differentials in establishing transportation prices leads to rates far in excess of the recourse rate; gives the pipeline an interest in the

commodity price of gas; and permits shippers to lock-in a profit margin and mitigate price risk, which provides increased price protection not available to recourse shippers.

8. IPAA states that the fundamental problem with negotiated transportation rates is that they tempt pipeline monopolies with negotiated rate authority to focus more attention on the opportunity to market gas than on their statutory obligation to provide non-discriminatory transportation. On this general note, the Industrials argue that negotiated transportation rate deals based on price differentials give pipelines a stake in the commodity price of gas on a particular day or at a particular location, thus effectively allowing pipelines to re-enter the gas commodity sales business. CPUC adds that transportation rates based upon commodity sales prices allow the pipeline to capture part of the commodity gas price and essentially makes it a partner in a merchant transaction. Mirant also asserts that index-based deals allow pipelines to compete directly with shippers in commodity markets.

9. Oklahoma and NASUCA argue that the use of basis differentials for negotiating transportation rates at best operates as a contractual mechanism to make additional profits, and at worst, operates as an incentive to withhold capacity. BP adds that such contracts provide an incentive for the pipeline to maximize revenue by selling any unutilized firm transportation as interruptible transportation and competing against the shipper's capacity. As such, it argues that this type of arrangement gives the pipeline an incentive to withhold operationally available capacity from the market for the purpose of increasing the commodity basis differential. Mirant states that the shippers and pipelines are not on an equal footing, because of the pipeline's control over capacity, the pivotal component of such trades. In addition, Mirant states that pipelines may have more information regarding the factors leading to differentials between index prices and may actually be able to influence such differentials through the operation of their systems.

10. CPUC opposes the use of negotiated rates in general and index-based rates in particular. CPUC states that evidence indicates that the California energy markets have been manipulated by traders and that spot market published commodity indices are not verifiable. Therefore, CPUC argues that it is unreasonable to continue the use of negotiated rates in

⁴ See Natural Gas Pipeline Co. of America, 101 FERC ¶ 61,125 (2002) (finding that a pipeline may not restrict the use of recourse rate bids and, thereby, deprive bidders of a cost of service rate alternative, by declaring that only negotiated rate bids would be considered valid for bidding in an open season to determine interest in a pipeline expansion project).

⁵ 74 FERC ¶ 61,076 at 61,240.

⁶ Notice of Inquiry Concerning Natural Gas Pipeline Negotiated Rate Policies and Practices, 100 FERC ¶ 61,061 (2002).

⁷ See Appendix for list of commenters.

⁸ See generally, comments of Oklahoma, Mirant, CPUC, NASUCA, BP, IPAA, and Calpine.