

place of tariff rates to serve markets or to simulate market behavior.

11. Other commenters argue that the Commission should continue to permit the use of basis differentials as a mechanism by which to set negotiated transportation rates. In essence, they maintain that these pricing methodologies represent a reasonable proxy for the value of the transportation and that the indexed rates allow shippers to easily engage in hedging programs and gas supply cost-management.<sup>9</sup> For example, INGAA argues that there is a relationship between the unregulated gas commodity price and the value of a pipeline's transportation, and that to achieve the Commission's goals of price transparency and market efficiency, the Commission should not place unwarranted restrictions on the ability to negotiate rates using basis differentials. INGAA argues that there is nothing inherently wrong about rates that reflect this market reality and that such rates protect shippers because the rate cannot exceed the basis differential.

12. The KM Pipelines and Williams argue that the Commission has recognized, in the context of evaluating the lifting of price caps in the short-term secondary market for released capacity, that basis differentials reflect the value placed by the market on the transportation capacity. Peoples and Duke Trading state that the price differential between points is a commonly accepted proxy for the value of transportation between such points. In the same vein, the KM Pipelines assert that, whether index-based pricing is permitted or not, the expected level of basis differentials will be a fundamental underlying consideration in contracting and, therefore, eliminating this pricing mechanism will not change the basic dynamics of the transaction.

13. Many commenters argue that the Commission should assume that most shippers that negotiate rates are sophisticated market participants, and that the Commission should not get involved in the pricing of such transactions beyond ensuring that the shipper always has the option of taking the recourse rate.<sup>10</sup> The AGA states that flexible and creative negotiations should not be inhibited by proscriptions against certain types of transactions such as those predicated on basis differentials.

MidAmerican adds that deals based upon price differentials are no different than fixed price negotiated rate deals, because in either circumstance, the shipper can always revert to a recourse rate. EPSA, Dominion, NGSA and Alliance argue, in essence, that restrictions on the types of rates that can be negotiated may unnecessarily reduce flexibility and the value of the program.

14. Williston Basin, TransColorado and EnCana maintain that it is difficult for pipelines to manipulate hub prices to increase profits. They assert that while the risk of manipulation is low, the potential benefits to shippers and pipelines are high, and shippers are more willing to acquire capacity when they can share the risk with the pipeline.

15. The Canadian Association of Petroleum Producers (CAPP) argues that the Commission should allow indexed-based rates, but that the Commission should ensure that pipelines entering into such arrangements do not withhold capacity from the market in order to affect commodity prices. CAPP asserts that the popularity of indexed rates demonstrates their appeal and that to prohibit them would potentially undermine the purposes of the negotiated rate program. KeySpan asserts that negotiated rate frameworks, such as those based on gas price differentials, respond to the needs of shippers and consumers and that there is no risk associated with these pricing structures that is not outweighed by their potential benefits.

#### *Discussion of Basis Differential Pricing Mechanisms*

16. The Commission has determined to modify its negotiated rates policy and will no longer permit the use of gas basis differentials to price negotiated rate transactions. Gas commodity price indices, when used as a negotiated pricing mechanism, usually reflect gas prices at different points, such as at gas basins or certain receipt and delivery points and citygates. The pricing mechanism is based upon the difference between the gas price indices at the two points. As discussed above, the basis differential pricing mechanism uses the difference in gas prices between two points, to reflect the value of transportation between such points. Thus, under this mechanism, the wider the difference between the points, the greater the value of the transportation. In the Commission's view, allowing the use of gas commodity basis differentials by a pipeline as a mechanism for pricing transportation by a pipeline with market power threatens the Commission's regulatory structure for the

transportation of gas as well as the Commission's attempts to improve and maintain a competitive natural gas commodity market.<sup>11</sup> This is because such mechanisms provide pipelines with an incentive to withhold capacity in an attempt to manipulate the gas commodity market by widening the differences between the indices.

17. In Order No. 637, the Commission discussed how its policies under traditional cost of service rate regulation limit the pipeline's market power stating:

The principal reason for limiting pipeline rates to a level that would permit recovery of a pipeline's annual revenue replacement is to limit the ability of the pipelines to exercise market power, so that the pipeline does not charge excessive rates. Without rate regulation, pipelines would have the economic incentive to exercise market power by withholding capacity (including not building new capacity) in order to raise rates and earn greater revenue by creating scarcity. Because pipelines are regulated, however, there is little incentive for a pipeline to withhold capacity, because even if it creates scarcity, it cannot charge rates above those set by its cost of service. Since pipelines cannot increase revenues by withholding capacity, rate regulation has the added benefit of providing pipelines with a financial incentive to build new capacity when demand exists.<sup>12</sup>

18. Subsequently, in *Tennessee*, the Commission examined the pipeline's incentive to withhold capacity in spite of the Commission's part 284 regulations prohibiting such action and determined that its traditional cost of service regulation that does not permit the pipeline to charge more than the maximum cost of service rate provided an adequate check on such incentives.<sup>13</sup>

19. However, the Commission's negotiated rate policy permits pipelines

<sup>11</sup> In Order No. 636, the Commission reviewed the House Committee Report leading to the Natural Gas Wellhead Decontrol Act of 1989, [Pub. L. 101-60, 103 Stat. 157 (1989)], which stated that the Commission's competitive open-access pipeline system should be maintained and that:

The Committee stresses that these new rules, and especially the wide adoption of blanket certificates for nondiscriminatory open access interstate transportation of non-pipeline gas, are essential to its decision to complete the decontrol process. All sellers must be able to reach the highest-bidding buyer in an increasingly national market. All buyers must be free to reach the lowest-selling producer, and to obtain shipment of its gas to them on even terms with other supplies. Order No. 636 at 30,397, H.R. Rep. No. 29 101st Cong. 1st Sess., at p 6.

In addition, the Commission noted that the House Committee Report urged the Commission "to retain and improve this competitive structure in order to maximize the benefits of decontrol." *Id.* (emphasis in original)

<sup>12</sup> Order No. 637 at 31,270.

<sup>13</sup> *Tennessee Gas Pipeline Co.*, 91 FERC ¶ 61,053 at 61,191 (2000), *order on reh'g*, 94 FERC ¶ 61,097 (2001), *aff'd*, *Process Gas Consumers Group v. FERC*, 292 F.3d 831 (DC Cir. 2002). (*Tennessee*)

<sup>9</sup> See, e.g., Comments of Alliance, ProLiance, Dominion, KM Pipelines, KeySpan, AGA, Peoples, EnCana, APSA, Northern Natural, MidAmerican, El Paso, Williston Basin, TransColorado, INGAA, Peoples, Duke Trading, Williams, EPSA and NGSA.

<sup>10</sup> See, e.g., Comments of NEG, El Paso, Peoples, Encana, WDG, MidAmerican and Alliance.