

to charge rates above the maximum cost of service rate thus presenting the possibility that a pipeline could increase revenues by withholding capacity. The Commission has relied on the availability of recourse service to prevent such an exercise of market power “by assuring that the customer can fall back to cost-based traditional service if the pipeline unilaterally demands excessive rates or withholds service.”¹⁴ As a general matter, this should be sufficient to prevent the pipeline’s exercise of market power, since ordinarily a shipper would be expected to choose the recourse rate in preference to a significantly higher negotiated rate.

20. However, this may not be true where the negotiated transportation rate is tied to the commodity price of gas. Such a negotiated rate may render the shipper indifferent to the actual costs of transportation. For example, a shipper may agree to an index differential-based, negotiated transportation rate with a pipeline. The shipper may then enter into gas sales agreements with its customers based upon the downstream price index that, in effect, lock in this transportation rate and/or a profit on the transaction. As a result, the shipper is indifferent to the price of gas at the downstream point and the pipeline’s withholding of capacity to manipulate the downstream commodity gas price (and the effect of such manipulation on the negotiated transportation rate). It has, in effect, shifted the possible risks of the pipeline’s abuse of its market power to the gas commodity market as a whole. In other words, negotiated transportation rates that use basis differentials to price transportation give the pipeline an incentive to withhold capacity so as to widen the basis differentials. In addition, the shipper may have little incentive not to agree since it is either held harmless or may, in fact, share in the profits from the increased price differential.¹⁵

21. In Order No. 636, the Commission stated that its primary goal was to improve the competitive structure of the natural gas industry and, at the same time, maintain adequate and reliable service. The Commission stated that its intent was to further “facilitate the unimpeded operation of market forces to stimulate the production of natural gas * * *.”¹⁶ The Commission thus

undertook the task of improving the benefits of the decontrol of natural gas prices—chiefly, abundant gas supplies at lower prices—through the maintenance and improvement of its competitive pipeline transportation system. To permit pipelines to utilize pricing mechanisms, such as those based upon natural gas commodity prices, which create powerful incentives for the pipelines to attempt to use their monopoly power to manipulate the prices of the competitive natural gas commodity market, is contrary to the Commission’s goal of improving the competitive pipeline transportation system set forth in Order No. 636.¹⁷

22. Pricing mechanisms that invest pipelines with an incentive to use market power to manipulate the commodity price of gas hinder the Commission’s attempt to maintain and improve the competitive natural gas market. To allow pipelines to acquire an interest in commodity prices, or more precisely the difference between the commodity prices at separate points, reverses the regulatory trend which is based upon the competitive transportation structure acting to ensure competitive natural gas markets. This interest in the prices of the natural gas commodity presents pipelines with an incentive to withhold existing capacity in order to manipulate natural gas prices and may also create a disincentive to invest in the expansion of capacity.¹⁸

23. While such pricing mechanisms may be useful in permitting parties to the negotiated agreement to engage in various hedging programs and gas supply cost-management programs, in the Commission’s view this flexibility cannot justify the increased risk of market manipulation faced by market participants. This slight limitation of transportation pricing flexibility is offset by the fact that negotiated rates may be based upon a virtually unlimited number of non-gas indices or other financial mechanisms that have no relationship with the commodity price of gas and are therefore not subject to manipulation through the withholding of pipeline capacity.

24. Accordingly, the Commission will no longer permit the pricing of negotiated rates based upon natural gas

commodity price indices. Negotiated rates based upon such indices may continue until the end of the contract period for which such rates were negotiated, but such rates will not be prospectively approved by the Commission.

Filing Requirements

25. As the Commission’s negotiated rate program has evolved, the Commission has clarified the filing requirements necessary for implementing such rates. In its original Policy Statement, the Commission stated that pipelines would need to file a tariff sheet indicating that the negotiated rate for a service would be either the rate stated on its existing rate schedule or a rate mutually agreed to by the pipeline and its customer. The Commission stated that when a rate is negotiated, the pipeline would need to file a numbered tariff sheet stating the exact legal name of the customer and the negotiated rate for the service.¹⁹

26. The Commission then modified this filing requirement to require that the pipeline file either the negotiated contract itself or a tariff sheet reflecting the essential elements of the negotiated rate agreement necessary to permit shippers that believe they are similarly situated to the shipper receiving the negotiated rate to make such a determination.²⁰ The Commission determined that if the pipeline chose to file a tariff sheet, the tariff sheet must contain the essential details of the transaction.²¹ In addition, the Commission required that the tariff sheet must include a statement affirming that the negotiated rate contract does not deviate in any material aspect from the form of service agreement in the pipeline’s tariff.²² The

¹⁹ 74 FERC ¶ 61,076 at 61,241.

²⁰ NorAm Gas Transmission Co., 75 FERC ¶ 61,091 (1996), *order on reh’g*, 77 FERC ¶ 61,011 at 61,037 (1996). 18 CFR § 154.1(b) (2003) provides that pipelines must file all contracts related to their services. An exception to this general requirement is permitted by 18 CFR 154.1(d) (2003) which states that although any contract which “deviates in any material aspect from the form of service agreement in the tariff” must be filed, it also states that any contract that conforms to the pipeline’s form of service agreement set forth in the pipeline’s tariff need not be filed.

²¹ The Commission stated that the tariff sheet “must state the name of the shipper, the negotiated rate, the type of service, the receipt and delivery points applicable to the service and the volume of gas to be transported.” 77 FERC ¶ 61,011 at 61,037 (1996).

²² The Commission’s regulations provide that the *pro forma* service agreement must refer to the service to be rendered and the applicable rate schedule of the tariff; and, provide spaces for insertion of the name of the customer, effective date, expiration date, and term. Blank spaces may be provided for the insertion of receipt and delivery

¹⁴ 74 FERC ¶ 61,076 at 61,240.

¹⁵ See, e.g., Transwestern Pipeline Co., 100 FERC ¶ 61,058 (2002), in which a shipper agreed to a negotiated transportation rate based upon a basis price differential that led to prices many times the pipeline’s maximum rate.

¹⁶ Order No. 636 at 30,393, *citing*, S.Rep. No. 39, 101 Cong., 1st Sess., at p. 2 (1989).

¹⁷ In Order No. 636, the Commission determined that because of firm transportation available under the rules promulgated by Order No. 636, and because of the abundance of uncommitted gas supplies available to replace pipeline sales of gas throughout North America, it would not be profitable for a pipeline to attempt to exercise market power over the sale of natural gas. Order No. 636 at 30,440.

¹⁸ See Tennessee Gas Pipeline Co., 91 FERC ¶ 61,053 (2000), *order on reh’g*, 94 FERC ¶ 61,097 (2001).