105 FERC ¶ 61,299
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, Joseph T. Kelliher,
and Suedeen G. Kelly.

Northern Natural Gas Company Docket No. RP00-152-002

ORDER ON REMAND

(Issued December 18, 2003)

1. This Order responds to the decision of the United States Court of Appeals for the District of Columbia Circuit (Court) vacating the Commission's rejection of Northern Natural Gas Company's (Northern) proposed revision of its tariff provisions concerning discounts.[1] The revision would have allowed Northern to implement an additional type of transportation discount "based on published index prices for specific receipt or delivery points or other agreed-upon pricing reference points for price determination," provided that the final rate remained between the maximum and minimum levels prescribed in the tariff.[2] The Commission held that such an index-based rate would constitute a negotiated rate, rather than a discounted rate, regardless of the provision that the rate remain within the pipeline's maximum and minimum recourse rates. The Court, however, found that the Commission failed to provide a reasoned explanation why the type of rate Northern proposed to offer could only be offered as a negotiated rate rather than a discounted rate. The Court accordingly granted Northern's petition for review and vacated the Commission's orders rejecting Northern's proposal. As discussed below, the Commission will accept Northern's revised tariff, subject to two changes.

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[1] Northern Natural Gas Co. v. FERC, No. 02-1107, 2003 U.S. App. LEXIS 14822.

[2] Northern Natural Gas Co., 90 FERC ¶ 61,064 (2000), <u>reh'g denied</u>, 98 FERC ¶ 61,106 (2002).

Background

2. The Commission's Part 284 open access transportation regulations, implemented by Order No. 436, permit pipelines to discount their transportation rates in order to maximize throughput. This benefits customers by spreading fixed cost recovery over more units of service. Consistent with this policy, § 284.10(c)(5) requires pipelines to file maximum and minimum transportation rates for both firm and interruptible service, with the minimum rate reflecting only variable costs. The pipeline is permitted to charge "an individual customer any rate that is neither greater than the maximum rate nor less than the minimum rate." When a pipeline enters into a discounted rate agreement, it generally need not file the discount agreement with the Commission. Since the rate falls within the range permitted by the tariff, the discount would not be considered a material deviation from the pipeline's form of service agreement under § 154.1(d) of the Commission's regulations.[3] However, if the discount is granted subject to the shipper meeting conditions not provided for in the tariff, then the pipeline would have to file the discount agreement.[4]

3. Since 1996, the Commission has also given pipelines the option to use negotiated rates as an alternative to cost-of-service ratemaking.[5] Under this option, the pipeline and a shipper may negotiate rates that vary from the pipeline's otherwise applicable tariff rates. Thus, unlike discounted rates, negotiated rates may exceed the pipeline's maximum rates or go below its minimum rates. However, pipelines must permit shippers to opt for use of the traditional cost-of-service "recourse rates" in the pipeline's tariff, instead of requiring them to negotiate rates for any particular service. The Commission

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[3] That regulation provides that contracts that materially deviate from the form of service agreement in the pipeline's tariff must be filed with the Commission. See Columbia Gas Transmission Corp., 97 FERC ¶ 61,221 at 62,001-3 (2001). The pipeline would have to post on its internet web site the details of the discounted rate agreement, including the name of the shipper, the rate charged under the contract, the maximum rate, and the quantity, duration, and receipt and delivery points involved. 18 C.F.R. § 284.13 (2003).

[4] See Transcontinental Gas Pipe Line, 87 FERC ¶ 61,050 (1999). For example, in return for a discount, the shipper might agree to a minimum flow requirement.

[5] Alternatives to Traditional Cost-of-Service Ratemaking for Natural Gas Pipelines, 74 FERC ¶ 61,076 at 61,238-242, reh'g, 74 FERC ¶ 61,194, reh'g, 75 FERC ¶ 61,024 (1996).

determined that the availability of the recourse rates would prevent pipelines from exercising market power by assuring that the customer can fall back to the just and reasonable tariff rate if the pipeline unilaterally demands excessive prices or withholds service. In order to implement a negotiated rate transaction, a pipeline must file either the negotiated rate agreement itself or a tariff sheet describing the agreement, since, unlike a discount, a negotiated rate is a material deviation from the pipeline's tariff.[6]

4. When a pipeline files a new section 4 rate case after granting a discount, it need not design its rates on the assumption that such discounted volumes would flow at the maximum rate. Rather, the Commission permits the pipeline to adjust the volumes used to design the pipeline's rates so that it will fully recover its cost-of-service if it continues giving the same discounts it gave during the test period. This avoids creating a disincentive to a pipeline offering discounts to maximize throughput.[7] However, the Commission has, for the most part, refused to permit similar adjustments with respect to negotiated rates.[8] The Commission stated that this was necessary to carry out its intention that no shippers other than those that have negotiated individual rates will be affected by the negotiated rate agreement.[9] In 1996, the Commission accepted tariff sheets filed by Northern giving it authority to negotiate rates.[10] In 1999, the Commission accepted a filing by Northern to set forth in its tariff six types of discounts that it may give. On December 29, 1999, Northern filed to add a seventh type of discount it might offer customers.[11] Northern proposed that the new discount would be:

> based on the published index prices for specific receipt or delivery points or other agreed-upon pricing reference points for price determination. Such

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[6] NorAm Gas Transmission Co., 75 FERC ¶ 61,091 at 61,309, reh'g, 77 FERC ¶ 61,011 at 61,037 (1996).

[7] Rate Design Policy Statement, 47 FERC ¶ 61,295 at 62,057 (1989).

[8] But see, e.g., Northwest Pipeline Corp., 79 FERC ¶ 61,416 at 62,763-4 (1997), accepting Northwest's proposal to make discount-type adjustments for discounted recourse rate contracts in narrowly defined circumstances.

[9] Northern Natural, 77 FERC at 61,137. See also NorAm. 77 FERC at 61,036.

[10] Northern Natural Pipeline Co., 76 FERC ¶ 61,026, reh'g, 77 FERC ¶ 61,035 (1996).

[11] Third Revised Sheet No. 303 to FERC Gas Tariff, Fifth Revised Volume No. 1.

> discounted rate may be based on the published index price point differentials or arrived at by formula.

5. Northern explained that the revised tariff would allow it to utilize index price-based discounted rates in cases where the actual rate is capped by Northern's maximum tariff rate and has a floor of its minimum tariff rate. Northern maintained that index-based rates are an important marketing tool for pipelines and shippers to avoid risk in today's competitive market. Northern also stated that the revised tariff provision would enable it to avoid the need for filing individual discount agreements of this type as negotiated rates or material deviations.

6. On January 27, 2000, the Commission rejected the proposed tariff sheet,[12] holding that Northern's proposal to use fluctuating index-based or formula rates in discounted transactions was contrary to Commission precedent and policy. Northern had contended that, because rates under its proposal would fall between the tariff's approved minimum and maximum rates, they constituted discount rates rather than negotiated rates. The Commission responded that an index-based rate is a negotiated rate, even if a particular index is restricted by maximum and minimum rates. In addition, the Commission clarified that previously approved discounted index-rates differed from Northern's proposal because in the previous cases, the discounted rate remained constant throughout the life of the contract once the level of discount was determined. By comparison, utilizing Northern's proposed tariff would allow the discounted rate to change multiple times over the duration of the contract.

7. On February 1, 2002, the Commission denied Northern's request for a rehearing.[13] Northern argued that the Commission had erred in focusing on the fact that the actual rate may fluctuate through use of an index or formula, rather than remaining fixed at a specified number for the duration of the contract. Northern further contended that a rate that fluctuates between an established maximum and minimum rate constitutes a discount rate rather than a negotiated rate. The Commission countered that nothing in its precedents contemplated allowing established discount rates to later fluctuate, and stated that Northern's contention "that any index-based rate which falls between the minimum and maximum rates constitutes a discount rate *per se* is overbroad."[14]

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[12] 90 FERC ¶ 61,064 (2000).

[13] 98 FERC ¶ 61,106 (2002).

[14] Id. at 61,323.

8. The Commission stated that, while a formula rate could form the basis for a discounted rate, a tariff provision permitting such discounted rates must:

> (1) define the rate component to be discounted, (2) make clear that the discounted, fixed rate resulting from the formula cannot exceed the maximum rate, nor be less than the minimum rate, (3) not change the underlying rate design, and (4) not include any minimum bill or minimum take provisions that has the effect of guaranteeing revenue.[15]

9. The Commission held that Northern's proposal did not satisfy these criteria, since it does not provide for a rate that is fixed and provides too much discretion for the use of any "index" or "formula".

10. On July 25, 2003, the Court vacated the Commission's orders rejecting Northern's filing, holding that the Commission failed to provide a reasoned explanation for its ruling. The Court noted that the Commission's main concern appeared to be that rates under Northern's proposed tariff would fluctuate during the duration of the contract. However, the Court found that the Commission had failed to explain why a fluctuating discount is problematic, so long as the charged rate remains within the parameters established by the tariff. The Court added that contrary to the Commission's position, there is nothing inherently "vague" about rate fluctuation, so long as the rate fluctuation is established by an objective criterion, such as a published index or formula as Northern's proposal requires. The Court also pointed out that the Commission's rules require Northern to post the details of all discounted rate agreements, so that other shippers can evaluate the discounts to determine if they are similarly situated. The Court concluded that the Commission failed to provide a reasoned explanation for rejecting Northern's proposal, and in particular for finding the rate collar in the present tariff insufficient to ensure the resulting discounts would yield reasonable rates.

11. In addition, after reviewing the decisions and authorities cited in the previous orders, the Court stated that the Commission had never clarified the distinction between discounted and negotiated rates. The Court noted that Northern contended that a discounted rate should be defined as any rate that deviates from the rate sheets but falls within the tariff range, whereas a negotiated rate need not fall within that range. The Court stated that the Commission has provided no coherent alternative definition of a discounted rate, and concluded, "Perhaps now it will do so or adopt the definition suggested by Northern."

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[15] Id.

Discussion

12. As further discussed below, discounted rates must stay within the maximum and minimum rates in the pipeline's tariff and be based on the same rate design as the tariff rates. Negotiated rates are not so limited. Accordingly, the Commission finds that pipelines may enter into discounted rate agreements that use formulas which produce fluctuating transportation rates during the term of the agreement, so long as the rates must remain within the range established by the maximum and minimum rates set forth in the pipeline's tariff. Also, because discounted rates are constrained by the pipeline's maximum tariff rates, the Commission will permit discounted rate formulas to be based upon gas commodity price differentials between different points, while maintaining our recently adopted policy of prohibiting the use of such price differentials in negotiated rate agreements.

13. Both the discounted rate program adopted in Order No. 436 and the subsequent negotiated rate program adopted after Order No. 636 permit pipelines to negotiate individualized rates with particular customers. Both programs also have the same fundamental purpose – to give the pipeline flexibility to meet competition so as to retain existing customers and attract new customers. However, the flexibility afforded the pipeline under the two programs differs.

14. As required by § 284.10(c)(5) of the regulations, discounted rates must fall within the range established by the pipeline's maximum and minimum tariff rates.[16] Pipeline tariffs set forth separate maximum and minimum rates for the reservation and usage charges for firm service. Discounted rates must also follow the same rate design as the pipeline's tariff rates. This is because any shifting of fixed costs from one rate component to the other would cause the maximum rate for the second rate component to be exceeded. Under the Commission's preferred straight fixed-variable (SFV) rate design, the maximum usage charge does not reflect any fixed costs, since all fixed costs are allocated to the reservation charge. Accordingly, a pipeline with an SFV rate design cannot offer a firm customer a discounted reservation charge in return for that customer's agreement to include some fixed costs in the usage charge, since the maximum usage charge would be exceeded.

15. Following pipeline restructuring pursuant to Order No. 636, the Commission determined that changes in the natural gas market resulting from the increased availability of unbundled transportation justified giving pipelines greater flexibility to

[16] A pipeline's minimum rate reflects only its variable costs. The maximum rate reflects both fixed and variable costs. § 284.10(c)(4) (2003).

negotiate individualized rates with customers than provided by the discounted rate program.[17] As described in the negotiated rate policy statement, the pipelines' existing firm customers, primarily local distribution companies (LDCs), no longer needed the same amount of capacity to their traditional pipeline's supply regions, and some wanted a greater ability to swing between pipelines to take advantage of the opportunity to purchase from different supply regions. As a result some pipelines were experiencing a problem with turned back firm capacity, and there were fears that the costs of that capacity could be shifted to the pipeline's captive customers, unless the pipeline was able to market it to new customers. At the same time, there was increased demand in the industrial and electric end-use markets. However, those customers could have particularized needs. For example, new electric generators argued that they needed long-term price certainty for transportation to finance gas dependent ventures. Also, greater ratemaking flexibility could allow pipelines to tailor transportation rates to meet the swings in gas consumption often experienced by electric generators.

16. Therefore, in the negotiated rate policy statement, the Commission allowed pipelines to negotiate individualized rates that were not constrained by the maximum and minimum rates in the pipeline's tariff. This also enabled pipelines to negotiate rates based upon a different rate design than that reflected in their tariff rates, for example by shifting fixed costs from the reservation charge to the usage charge. Additionally, it permitted pipelines, as a means of providing rate certainty, to negotiate a fixed rate that would continue in effect regardless of changes in the pipeline's maximum rate. Thus, the fundamental distinction between discounted rates and negotiated rates is that discounted rates must remain within the range established by the pipeline's maximum and minimum tariff rates and must reflect the same rate design as the tariff rates, but negotiated rates are not subject to either of those restrictions.

17. Given this distinction between discounted and negotiated rates, the Commission finds that rate formulas that produce varying rates during the term of an agreement are permissible as discounted rates, so long as the rate remains within the range established by the maximum and minimum rates set forth in the pipeline's tariff. There is nothing in the Commission's regulations that prohibits such a varying rate as a discount. Section 284.10(c)(5) permits the pipeline to charge individual customers "any rate" between the maximum and minimum rate. Moreover, the Commission has repeatedly held that the purpose of its discounted rate program is to allow pipelines to compete for customers who have alternatives. The Commission has found that this allows the pipeline to generate greater throughput over which to spread its fixed costs, thus

[17] Alternatives to Traditional Cost-of-Service Ratemaking, 74 FERC at 61,225-6.

benefiting all customers.[18] Formula-based discounts provide the pipeline an additional tool to meet competition, consistent with the underlying purpose of the Commission's discount policy. For example, a potential customer may have the ability to use an alternate fuel. The pipeline's offering of a discounted formula rate that varies with variations in the cost of the alternate fuel may help the pipeline meet competition from the alternate fuel.

18. Since the issuance of the orders rejecting Northern's proposal, which the Court rejected, the Commission has changed policy on several related matters. For the reasons discussed below, the Commission finds that those policy changes do not provide a basis for rejecting Northern's instant proposal. First, Northern's proposal would permit formula-based discounts that rely on the differential between gas commodity index prices at different points, commonly referred to as basis differentials. In a policy statement issued on July 25, 2003,[19] the Commission modified its negotiated rates policy to no longer permit the use of gas basis differentials to price negotiated rate transactions. In essence, the revised policy was based on a concern that, because negotiated rates may exceed the pipeline's maximum recourse rate, negotiated rates tied to basis differentials could give the pipeline an incentive to withhold capacity in an attempt to manipulate the gas commodity market by widening the differentials between the indices. A number of parties have requested rehearing of the July 25 policy statement. Among other things, they contend that basis differentials are a reasonable way of placing a value on the transportation of gas and that such a pricing methodology permits flexibility and allows parties to engage in hedging transactions. The Commission is currently considering these requests to reconsider the policy against the use of basis differentials in negotiated rate transactions.

19. Regardless of the approach the Commission ultimately takes with respect to the use of basis differentials in negotiated rate transactions, the Commission has determined to permit the use of basis differentials in the formulas used to establish discounted rates. The concerns about the use of basis differentials in negotiated rates set forth in the July 25 policy statement are not present to the same degree in the context of discounted

[18] Policy Statement Providing Guidance with Respect to the Designing of Rates, 47 FERC ¶ 61,295 at 62,046 n. 44 (1989), citing Order No. 436 at 31,546 n.1. Order No. 436-A, FERC Stats. & Regs., Regulations Preambles 1982-1985 ¶ 30,675 at 31,679 (1985). Southern Natural Gas Co., 67 FERC ¶ 61,155 at 61,456-8 (1994). Williston Basin Interstate Pipeline Co., 85 FERC ¶ 61,247 at 62,028-9 (1998).

[19] Natural Gas Pipeline Negotiated Rate Polices and Practices; Modification of Negotiated Rate Policy, 104 FERC ¶ 61,134 (2003).

rates based on basis differentials. That is because discounted rates, unlike negotiated rates, are capped by the pipeline's maximum cost-of-service rate. Thus, any concern about basis differential pricing giving the pipeline an incentive to withhold capacity in order to achieve higher revenues than would be possible under its maximum cost-of-service rates should be less in the discounted rate context. Given this fact, the Commission finds that the benefits of allowing the use of basis differentials to price transportation service in discount agreements outweigh any potential harm through giving the pipeline an incentive to withhold capacity. The difference in gas commodity prices between two points on a pipeline's system is a reasonable proxy for the value of the transportation between those two points, absent market manipulation. Thus, use of basis differentials to pricing transportation service enables the pipeline and shipper to negotiate market sensitive transportation rates, consistent with the Commission's goal of encouraging competition in the transportation capacity market. Also, basis differential pricing allows shippers to easily engage in hedging programs and gas supply cost management. Finally, as the Court noted, the risk of undue discrimination in the offering of such discounts is minimized by the fact the Commission's rules require Northern to "post the details of all discounted rate agreements, so that similarly situated shippers will be able to evaluate the discounts – even if they fluctuate – and avail themselves of the discounted rates if they so choose."[20]

20. While the Commission will, consistent with the above discussion, permit Northern to implement its proposed tariff provision authorizing it to offer discounts based on basis differentials, the Commission does require Northern to revise its proposal to ensure that all such discount agreements use the same rate design as the pipeline's tariff rates. Specifically, Northern must provide that any service agreement containing such a discount identify what rate component (i.e. reservation charge or usage charge or both) is discounted. Also, Northern must provide that, to the extent the firm reservation charge is discounted, the basis differential rate formula will produce a rate per unit of contract demand.[21] This will ensure that the discounted reservation charge will always be billed

[20] Northern Natural Gas Co., 2003 U.S. App. 14822, at *6.

[21] In other words, a formula, if used for discounting the reservation charge, would have to generate a reservation rate less than the rate schedule's maximum reservation rate that would then be applied to the customer's reservation quantity under the discounted service agreement. Pipelines with two-part rates for firm service that are not SFV in design, as is the case with Northern, have the additional flexibility to discount fixed costs that are in the usage rate down to the minimum usage rate under the rate schedule. In both instances, however, if a formula is used it must produce a reservation rate and usage rate to be applied to the applicable service quantities.

based on the shipper's contract demand, as is appropriate for a reservation charge, and is not billed based on the shipper's throughput.

21. Second, the Commission recently issued a policy statement in Price Discovery in Natural Gas and Electric Markets,[22] requiring that any prospective use of any index in the Commission's jurisdictional tariffs must meet certain specified criteria and reflect adequate liquidity at the referenced location to be reliable. In subsequent cases, where pipelines have proposed tariff provisions that include the use of index prices not previously included in the pipeline's tariff, the Commission has directed staff to investigate whether the index meets the standards set forth in the policy statement and reflects adequate liquidity.[23] Consistent with the fact that pipelines are not required to file individual discount agreements with the Commission for its approval, the Commission will not require that every individual discounted rate agreement using basis differentials be filed for a review of the pricing indices the parties have chosen to use. Because the price index will only be used to determine the discounted rate in a particular transaction where the customer has agreed to the use of that price index, and because the discounted rate cannot in any event exceed the maximum just and reasonable rate set forth in the pipeline's tariff, the Commission will permit such agreements to be implemented without its approval of the chosen index. In the discounted rate situation, there is not the same need for Commission review as in the situation where the pipeline is proposing to include a price index in a generic tariff provision applicable to all its customers, such as its cash-out mechanism, regardless of whether they have agreed to the use of the particular index.

22. Accordingly, we will approve Northern's proposed tariff sheet, subject to it filing the changes discussed above.

The Commission orders:

(A) Northern's proposed tariff sheet is hereby accepted, effective January 1, 2004, subject to the changes required in Ordering Paragraph (B).

[22] 104 FERC ¶ 61,121 (2003) (Index Price Policy Statement).

[23] See, e.g., Northern Natural Gas Co., 104 FERC ¶ 61,182 (2003).

(B) Within 20 days of the date of this order, Northern must file revised tariff sheets consistent with the discussion in the body of the order.

By the Commission.

(S E A L)

Magalie R. Salas,
Secretary.