101 FERC ¶ 61, 127
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
William L. Massey, Linda Breathitt,
and Nora Mead Brownell.

Regulation of Short-Term Natural Gas Transportation Services, and Regulation of Interstate Natural Gas Transportation Services — Docket No.RM98-10-011

ORDER ON REMAND

(Issued October 31, 2002)

1. In Interstate Natural Gas Association of America v. FERC, 285 F.3d 18 (D.C. Cir. 2002) (INGAA), the United States Court of Appeals for the District of Columbia remanded certain issues to the Commission regarding Order No. 637.[1] This order responds to the Court's remand. It removes the term matching cap for the right of first refusal (ROFR). It clarifies that a tariff that is contrary to the ROFR governs service on the pipeline until changed under Section 5, while one that is silent or ambiguous will be interpreted as consistent with the ROFR. It also affirms the Commission's prior holding that a segmented transaction consisting of a backhaul and a forwardhaul to the same point that exceed contract demand is permissible. Last, it finds that the issue of conditions on waiver of the posting and bidding requirements for short-term capacity releases by local distribution companies (LDCs) is moot.

## Procedural Background

2. While the D.C. Circuit generally affirmed Order No. 637, the Court remanded four issues to the Commission. As detailed further below, the Court remanded for the

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[1] Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,091 (February 9, 2000); order on reh'g, Order No. 637-A, FERC Stats. & Regs, Regulations Preambles (July 1996-December 2000) ¶ 31,099 (May 19, 2000); order denying reh'g, Order No. 637-B, 92 FERC ¶ 61,062 (2000).

Commission to explain: (1) why it continued the five-year term matching cap for the right of first refusal (ROFR), (2) whether it intended the ROFR in its regulations to govern regardless of any contrary provision in a pipeline's tariff, (3) whether its requirement that pipelines permit forwardhauls and backhauls to the same point requires modification of the pipeline's contracts with its shippers, and (4) why it required that if the LDC wants waiver of capacity release posting requirements, it must be prepared to have all its capacity release transactions limited to the applicable maximum rate for pipeline capacity.

3. On May 31, 2002, the Commission issued a notice requesting comments on the four issues remanded by the Court (May 31 Order).[2] The purpose of the notice was to enable the Commission to decide the remanded issues with the benefit of the views of all interested parties. The Commission has considered these comments in determining the responses below.

## I. Right of First Refusal Term Matching Cap

4. The Court reversed and remanded Order No. 637's policy that shippers exercising their right of first refusal (ROFR) to retain capacity need only match contract term lengths of up to five years. For the reasons expressed below, the Commission determines that the term matching cap should be removed.

### Background

[2] Regulation of Short-Term Natural Gas Transportation Services, and Regulation of Interstate Natural Gas Transportation Services, 99 FERC ¶ 61,245 (2002).

5. The ROFR originated in Order No. 636,[3] where the Commission tempered the pipeline's pre-granted authority to abandon contracts upon their termination with a ROFR for firm customers with a contract longer than one year.[4] Specifically, the Commission adopted a regulation providing that such a shipper could retain its service under a new contract by matching the term and the rate (up to the maximum rate) offered by the highest competing bidder.[5] In Order No. 636-A, the Commission capped the contract length the existing shipper must match at twenty years.

6. On appeal of Order No. 636, the Court found the twenty-year cap was not justified by the record and remanded it for further explanation.[6] The Court stated that the Commission had not adequately explained how the twenty-year term matching cap protects against the pipelines' preexisting market power, particularly why the twenty-year cap would prevent bidders on capacity constrained pipelines from using long contract duration as a price surrogate to bid beyond the maximum approved rate, to the detriment of captive customers. On remand in Order No. 636-C, the Commission changed its policy and adopted a five-year term matching cap. It relied on the fact most commentors in the Order No. 636 proceeding had supported a term matching cap in the range of five

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[3]Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, Order No. 636, 57 Fed. Reg. 13267 (April 16, 1992), FERC Statutes and Regulations, Regulations Preambles January 1991-June 1996 ¶ 30,939 at 30,446-48 (April 8, 1992); order on reh'g, Order No. 636-A, 57 Fed. Reg. 36,128 (August 12, 1992), FERC Statutes and Regulations, Regulations Preambles January 1991- June 1996
¶ 30,950 (August 3, 1992); order on reh'g, Order No. 636-B, 57 Fed. Reg. 57,911 (December 8, 1992), 61 FERC ¶ 61,272 (1992); reh'g denied, 62 FERC ¶ 61,007 (1993); aff'd in part and remanded in part, United Distribution Companies v. FERC, 88 F.3d 1105 (D.C. Cir. 1996); order on remand, Order No. 636-C, 78 FERC ¶ 61,186 (1997).

[4]Order No. 636 at 30,446-48.

[5]18 C.F.R. § 284.221(d)(2)(ii) (2001).

[6]United Distribution Companies v. FERC, 88 F.3d 1105, 1140-41 (D.C. Cir. 1996) (UDC).

years and more recent evidence showed that five years was about the median length of all contracts of one year or longer between January 1, 1995 and October 1, 1996.[7]

7. On rehearing in Order No. 636-D, the Commission recognized that pipelines had raised legitimate concerns about whether the five-year term matching cap was causing a bias toward short-term contracts, with adverse economic consequences for both pipelines and captive customers. The Commission, however, deferred further consideration of the term cap to the proceeding which became the Order No. 637 proceeding in Docket No. RM98-10-000, where a more current record could be developed. In Order No. 637, the Commission continued the five-year cap policy, finding that none of the parties presented evidence to support the conclusion that a five-year contract is atypical in the current market.

8. On appeal, the Court found that the Commission had not addressed the objections that had been raised concerning the five-year cap and had relied on the same evidence that it had used to make its decision in Order No. 636-C, namely the fact that five years was about the median length of all contracts of one year or longer. [8] The Court concluded that the only evidence supporting the Commission's final decision to choose a five-year cap was the original record, which in the Commission's own view was incomplete. The Court held the Commission had neither given an affirmative explanation for its selection of five years, nor had it responded to its own or the pipelines' objections to the five-year cap. The Court also questioned why the Commission used a median to function as a ceiling. The Court thus vacated the five-year cap and remanded the issue to the Commission.

## Discussion

9. The Commission has determined, on remand, to remove the term matching cap for the reasons discussed below. As a result of this determination, an existing customer seeking to renew an expiring contract would have to match the term in a third party bid, regardless of its length.

10. The Commission's regulations pregrant to pipelines the authority to abandon open access transportation service to a customer following the expiration of that customer's contract. In order to pregrant abandonment, the Commission must make a generic

[7]Order No. 636-C at 61,774 and 61,792.

[8]INGAA at 53.

finding under NGA section 7 that such pregranted abandonment is in the public convenience and necessity. In UDC, 88 F.3d at 1139, remanding Order No. 636-A's choice of a twenty-year term-matching cap, the Court held that in order to make the requisite finding of public convenience and necessity in this context, "the Commission must make appropriate findings that existing market conditions and regulatory structures protect customers from pipeline market power." The Court therefore held that in analyzing the term-matching cap in the ROFR adopted by Order No. 636-A, "the issue is whether the Commission has shown that its choice of a twenty-year term-matching cap protects consumers against the exercise of pipeline market power." [9]

11. It follows that whether a term-matching cap must be required as part of the ROFR turns on whether such a term-matching cap is necessary to protect the existing long-term shipper from the pipeline's exercise of market power. In responding to the remand of the Order No. 637 term cap issue, the Commission finds that no term cap is necessary for this purpose, based on the reasoning in Tennessee Gas Pipeline Co., [10] recently affirmed in Process Gas Consumers Group v. FERC.[11] Market power is exercised through the withholding of capacity to create an artificial scarcity, thereby raising prices. In Tennessee, the Commission addressed whether a term-matching cap is necessary to control a pipeline's exercise of market power when a net present value method is used to allocate scarce unsubscribed capacity between two shippers not currently on the system. The Commission found that its existing regulatory controls are sufficient to constrain pipelines from withholding capacity to pressure shippers into longer contracts than they desire, without the need for any term-matching cap.

12. These controls include limiting the rates pipelines can charge to maximum just and reasonable levels and requiring pipelines to sell all available capacity to shippers willing to pay the maximum rate. Therefore, the Commission found, the only way a

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[9]UDC, 88 F.3d at 1140 ("For purposes of pre-granted abandonment, however, the issue is whether the Commission has shown that its choice of a twenty-year term-matching cap protects consumers against the exercise of pipeline market power. . . . The Commission has not explained why the twenty-year cap will prevent bidders on capacity constrained pipelines from using long contract duration as a price surrogate to bid beyond the maximum approved rate, to the detriment of captive customers.")

[10]Tennessee Gas Pipeline Co., 91 FERC ¶ 61,053 (2000), reh'g, 94 FERC ¶ 61,097 (2001).

[11]292 F.3d 831 (D.C. Cir. 2002) (PGC).

pipeline could create scarcity to force shippers to accept longer term contracts would be to refuse to build additional capacity when demand requires it. However, the Commission found pipelines would have a greater incentive to build new capacity to serve all the demand for their service, than to withhold capacity, since the only way the pipeline could increase current revenues and profits would be to invest in additional facilities to serve the increased demand. Moreover, if Tennessee did refuse to build new capacity, the shippers could file a complaint. The Commission also found that its regulations prohibit Tennessee from favoring or colluding with its affiliates to manipulate the market through sham bids.

13. The Court affirmed this reasoning, stating:

> These several rationales for uncapping the NPV bidding process . . . address our principal concern . . . – FERC's failure to articulate how a twenty-year cap would prevent Tennessee from exploiting its monopoly power. No longer relying on a cap to accomplish that objective, FERC now explains that other regulatory constraints adequately limit Tennessee's ability, as well as any incentive, to induce lengthy contracts. We think this persuasive for two reasons. First, because the Commission already regulates the rates pipelines may charge and requires them to sell all available capacity at those rates, we agree with FERC that Tennessee has neither the legal ability to withhold existing capacity nor an incentive to refuse to build new capacity. Second any effort by Tennessee affirmatively to manipulate the bidding process would violate other Commission rules and would therefore presumably be actionable. Accordingly, as FERC argues, the fact that shippers may at times bid up contract length likely reflects not an exercise of Tennessee's market power, but rather competition for scarce capacity.[12]

14. As discussed in PGC, in the ROFR context, unlike the NPV context, the Commission must find under NGA § 7(b) that pre-granted abandonment is in the public convenience and necessity.[13] This requirement is fulfilled because the ROFR ensures that, if the existing customer is willing to pay the maximum approved rate and match the contract term of a rival bidder, the pipeline may not abandon service to that customer. UDC, at 1140-41. Thus, even a captive customer served by a single pipeline can retain

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[12] PGC at 837.

[13] PGC, at 838.

its long-term firm transportation service against rival bidders, and therefore is provided the protection from pipeline market power required for pre-granted abandonment under § 7. Id.

15. The issue is whether the ROFR contract term-matching requirement allows pipelines to exercise market power, so that a term cap on the ROFR is also required for existing shipper protection. UDC, at 1140. For the reasons stated in Tennessee and PGC, discussed above, the Commission finds that, because "other regulatory constraints adequately limit [the pipeline's] ability, as well as any incentive, to induce lengthy contracts," PGC, at 837, no term cap is required to protect existing captive customers exercising their ROFR from pipeline market power. As the PGC Court observed, "the fact that shippers may at times bid up contract length likely reflects not an exercise of [the pipeline's] market power, but rather competition for scarce capacity." Id.

16. Removing the term-matching cap satisfies the various concerns the INGAA Court found the Commission had not adequately addressed in Order No. 637. These include the concern that a cap fosters an imbalance of risks between pipelines and existing customers and adversely affects the efficient allocation of capacity, such as putting capacity in the hands of those who value it the most.

17. Removing the term cap also addresses the difficulties with the five-year cap, which the Court in INGAA held the Order No. 637 did not sufficiently address. These are that the five-year cap provides a disincentive for existing shippers to enter into a contract of more than five years, and thus the five-year cap results in a bias toward short-term contracts. Pipelines such as Great Lakes Gas Transmission L.P. and Williston Basin Interstate Pipeline Company assert that the five-year cap gives ROFR holders a market advantage by allowing them to hold pipelines to a perpetual service commitment which, at the same time, increases the risks to pipelines of stranded capacity. Thus, the five-year cap may cause an imbalance of risks as between the existing shippers and the pipeline, giving the shippers indefinite control over the pipeline's capacity, while giving the pipeline no corresponding protection from ultimately being stuck with stranded capacity.

18. Removing the term cap also avoids the difficulty, pointed out in Tennessee and upheld by the Court in PGC, that the Commission has no way of estimating what contract terms a competitive market would produce, since there is no widespread competitive market for primary pipeline capacity. The data the Commission has concerning terms in existing contracts are for service on regulated pipelines. Such data "provides no basis for

estimating what contract terms would be in a truly competitive market." [14] Moreover, "establishing any cap absent evidence concerning contract terms in a competitive market might prevent the customer who values the capacity the most from getting it, since it could not bid the longer term it actually wants."[15]

19. The non-pipeline parties who argue for keeping the current five-year term-matching cap urge that a cap is necessary because captive customers must retain their capacity and therefore must match any third party bid. They argue that this could lead captive customers to have to match an extremely long-term bid by a third party.[16] However, at the same time, these parties contend the five-year term-matching cap has not led to shorter contract terms than would otherwise occur, since non-captive customers have generally been able to negotiate contract terms of less than five years and do not desire longer term contracts because of the risk that their needs will change. For example, the American Gas Association, relying on Index of Customer data filed January, 2002, for contracts with effective dates after January 1, 1999, indicates that 49% of the contracts are for less than three years and only 6.4% had terms of exactly five years so that the five-year cap does not distort the market.[17] Mississippi Valley Gas Company asserts the five-year cap has not caused a significant reduction in the length of long-term contracting, citing the Commission's contract data in Table I of the Commission's May 31, 2002 notice requesting comments.[18] The American Public Gas Association also cites Table I of the May 31 order noting that almost 60% of the contracts with terms of five

[14] Tennessee, 91 FERC at 61,191.

[15] Id.

[16] The American Gas Association and The Missouri Public Service Commission are both concerned that captive customers could be forced into contracts with longer terms than they desire. The American Gas Association states local distribution companies do not bid on an equal footing with other shippers because they are responsible for meeting retail demand. Wisconsin Distributor Group and Colorado Springs Utilities assert they could be forced into long-term contracts if faced with a longer term cap.

[17] Comments of the American Gas Association at 12-13.

[18] Regulation of Short-Term Natural Gas Transportation Services, and Regulation of Interstate Natural Gas Transportation Services, 99 FERC ¶ 61,245 (2002) (Table I).

years or less had terms of one to two years, while only about 15% had terms of five years, so that the five-year cap is not driving the market.

20. These facts suggest that it is unlikely the pipeline will be able to obtain bids significantly in excess of five years in order to present to the existing shipper for matching. To the extent a new customer does value the capacity sufficiently to make a long-term bid, then requiring the existing shipper to match such a bid, helps ensure that the capacity goes to the shipper that values it the most. The INGAA Court recognized this as a legitimate goal, when it spoke of balancing the protection of captive customers with "the furtherance of market values (putting capacity in the hands of those who value it the most)." [19]

21. The non-pipeline customers seeking a continuation of the five-year term matching cap do not directly attack the Commission's analysis in Tennessee finding that current regulatory controls minimize the ability of pipelines to use their market power to force captive customers to enter into longer term contracts than would be required in a competitive market. However, some non-pipeline customers suggest that pipeline affiliates or others, knowing the existing customer must match any term that is bid, may make artificial long-term bids just to force the existing customer to execute a very long-term contract.

22. The Commission believes that non-affiliated customers of the pipeline are unlikely to make bids for a longer term than they are willing to commit to just to force the existing shipper into an unfavorable contract. Such a course would always carry some risk that the existing customer would not match the third party bid and the third party would be stuck with a contract it did not desire. If the third party bidder is an affiliate of the pipeline and the existing customer does not believe the bid is bona fide, the customer may use the Commission's complaint process to review the bid.

## II. Relationship of ROFR to Tariff Provisions

23. The Court remanded, without vacating, a second issue concerning the ROFR. In Order No. 637, the Commission stated that shippers always have the ROFR set forth in 18 C.F.R. § 284.221(d), regardless of the provisions set forth in their contract.[20] In Order No. 637-A, the Commission stated that shippers' regulatory ROFR is effective

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[19] INGAA at 52.

[20] Order No. 637 at 31,341.

"regardless of the terms of any tariff."[21] The Court found that the Commission had not adequately explained whether, through these statements, the Commission intended to provide that the regulatory ROFR is self-executing and applies regardless of any inconsistent language in the pipeline's tariff, or whether tariff language is necessary to effect the right. Accordingly the Court remanded this issue to the Commission to explain its current position on this issue and, to the extent that the language in the Order Nos. 637 and 637-A is legally unsustainable, to modify it.

24. As discussed below, the Commission finds that in the circumstances involved here, where pipelines were required to implement the ROFR through tariff provisions and the tariff is not consistent with Commission policies, the approved tariff governs[22] until it is changed by the Commission under Section 5. However, if an approved, existing tariff is silent or ambiguous on this issue, the regulatory ROFR is controlling.[23]

**Background**

25. As indicated above, Order No. 636 tempered pipelines' pre-granted abandonment authority by establishing a ROFR under Section 7(b) to protect customers.[24] The ROFR

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[21]Order No. 637-A at 31,647.

[22]Section 4(d), NGA (a natural gas company shall not make any change in its service unless it files the change 30 days in advance with the Commission); 18 C.F.R. § 154.3 (2002) (a natural gas company must not impose any practice different from those prescribed in its effective tariff on file with the Commission unless otherwise specifically ordered by the Commission).

[23]The determination of whether a regulatory provision governs may be dependent on the circumstances of a particular case, and the Commission is not developing here a rule of general applicability that will apply in all cases of potential conflict between regulatory policies and tariff provisions.

[24]Order No. 636-A at 30,632. "The ROFR will protect customers because it permits the existing customer to retain service. The pipeline is not able to refuse transportation service at the end of the contract term or to make monopolistic demands as a condition for continued service." The ROFR was codified at 18 C.F.R. § 284.221(d)
(continued...)

consisted, in part, of regulatory requirements and, in part, of Commission policies. The ROFR regulatory provisions allowed a firm shipper with a contract of one year or more to continue its transportation arrangement by matching the longest term and highest rate for its firm service, up to the maximum rate, that was offered by any other person. The Commission implemented the regulatory requirements of the ROFR by requiring pipelines to include them in their tariffs. The Commission's ROFR policies, among other things, permitted firm shippers with a contract of one year or more to retain a portion[25] of their capacity if they matched the longest term and highest rate for that capacity, up to the maximum rate, offered by any other person. The Commission did not require pipelines to include this policy in their tariffs.

26. In Order No. 636, the Commission considered at length the relation between the ROFR established in its regulations and policies and contracts between pipelines and shippers. The Commission stated pipelines and shippers could include rollover or evergreen clauses in their contracts if they wished. But if they did not, the Commission stated the ROFR would be available to customers even if they did not have a rollover or evergreen clause in their contracts and customers without such contract clauses could retain their capacity by exercising their ROFR and matching the longest term and highest rate offered by any other person for the capacity.[26]

27. Subsequently, in Order No. 637, the question again arose of the relationship of the regulatory ROFR to shippers' contracts.[27] Customers asked whether they could retain a volumetric portion of their capacity subject to the ROFR if their contracts contained a rollover or evergreen clause. They said pipelines were contending that the ROFR applied only when a shipper's contract did not contain a rollover or evergreen clause. The Commission explained that shippers always have the regulatory ROFR at a minimum. It stated the ROFR is not dependent on contract and that a shipper's contract may broaden the regulatory ROFR, but may not narrow it. The Commission stated the ROFR includes the right of the shipper to elect to retain a volumetric portion of its capacity subject to the ROFR and permit the pipeline's pregranted abandonment to apply

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[24](...continued)
(2)(ii).

[25]Order No. 636-A at 30,634-35.

[26]Order No. 636-A at 30,628.

[27]Order No. 637 at 31,341.

to the remainder of the service. Thus, the Commission clarified that a customer with a contract that qualifies for a ROFR (in terms of duration, and, now, maximum rate) may exercise that regulatory right for a volumetric portion of the capacity regardless of whether its contract contains a rollover or evergreen clause.

28. In Order No. 637-A the issue arose of whether a shipper could give notice of termination and retain a volumetric portion of its capacity subject to a ROFR when a pipeline's tariff allegedly did not provide for any ROFR rights unless the pipeline gave notice of termination.[28] The Commission stated that the regulatory ROFR permits the shipper to retain a volumetric portion of its capacity regardless of the terms of any tariff. The Commission stated, however, that it would not address any tariff-specific issues in the Order No. 637 proceeding and that any such issues would be addressed in the individual compliance filings.[29]

29. Subsequently, the Commission reviewed filings by Gas Transmission Co. (Algonquin) and Texas Eastern Transmission Corp. (Texas Eastern) that, among other things, sought to revise their tariffs to restrict the ROFR to shippers paying the maximum rate and to permit shippers to terminate a volumetric portion of their capacity and exercise ROFR rights with respect to the portion they retained.[30] In reviewing these filings, the Commission found that the pipelines' existing tariffs, which had been approved under Order No. 636, appeared to be inconsistent with the proposed provisions and with Order Nos. 636 and 637 because they provided that shippers could only exercise the ROFR with respect to their capacity when the pipeline served notice of termination and not when the shipper served notice of termination. The order stated that the tariff provisions should be consistent in allowing the ROFR to apply whether the customer or the pipeline provides notice and directed the pipelines to file revised tariff sheets providing for ROFR provisions to apply whether the customer or the pipeline provides notice of termination.

30. On rehearing in these proceedings, Algonquin and Texas Eastern argued that the Commission's requirements were contrary to its holdings in their Order No. 636 compliance filings, that they unlawfully expanded the ROFR rights of shippers, and that

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[28]Order No. 637-A at 31,647.

[29]Order No. 637-A at 31,646-47.

[30]Algonquin Gas Transmission Co., 93 FERC ¶ 61,014 (2000);Texas Eastern Transmission Corp., 93 FERC ¶ 61,016 (2000).

they constituted an inappropriate fundamental change in their contractual relationship with their shippers. The Commission in a single rehearing order for both proceedings[31] affirmed that the existing tariff provisions appeared to be inconsistent with the ROFR protection mandated in both Order Nos. 636 and 637. The Commission stated, however, that it had previously found the existing tariff provisions to be just and reasonable under Section 5 and that, therefore, further findings were necessary under Section 5 if they were to be modified. The Commission established separate tariff investigations pursuant to Section 5 to determine whether each pipeline's current tariff affords its shippers the minimum ROFR protection and issued orders to show cause to both pipelines why their existing tariffs should not be changed to bring their language into conformity with the Commission's ROFR protections.

31. The Court in INGAA found that the Commission's decisions in the Algonquin and Texas Eastern proceedings appeared to be contrary to its holdings in Order No. 637 and were, therefore, confusing. The Court noted that in the Algonquin and Texas Eastern proceedings, the Commission had required that Section 5 findings be made to change the pipelines' ROFR tariff provisions, while in Order No. 637, the Commission stated that the ROFR was self-executing and prevailed, regardless of a pipeline's tariff. As stated above, the Court remanded this issue to the Commission for an explanation and modification, if necessary, of its current position.

**Discussion**

32. Local distribution company (LDC) commentors support the view that the regulatory ROFR is self-implementing and argue that the regulatory ROFR should trump tariff provisions. The two pipeline commentors on this issue, Northern Natural Gas Company and Williston Basin Interstate Pipeline Company, hold the contrary view, arguing that the ROFR is not self-executing and also that any approved tariff provisions different from Commission regulations or policy concerning the ROFR provision should govern.

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[31] Order Granting Rehearing in Part, Denying Rehearing in Part, and Instituting Investigation, Algonquin Gas Transmission Co., Docket No. RP00-533-001, Texas Eastern Transmission Corp., Docket No. RP00-535-001, 94 FERC ¶ 61,383 (2002); Order Denying Clarification and Rehearing, Algonquin Gas Transmission Co., Docket No. RP00-533-002, Texas Eastern Transmission Corp., Docket No. RP00-535-002, 95 FERC ¶ 61,303 (2001).

33. The Commission explains and clarifies its position on the ROFR contained in its regulations as follows. Section 284.221(d) of the Commission's regulations[32] sets forth in only very general terms the requirement that pipelines provide a ROFR to long-term, maximum rate shippers. Many of the details concerning shippers' ROFR rights are not included in the regulation, but have been established as matters of policy, set forth either in the preambles to Order Nos. 636 and 637 or in individual cases. For example, the regulation does not specifically address the shipper's right to exercise its ROFR to retain only a volumetric portion of its current contract demand. The Commission established that right in the preamble to Order No. 636-A, without modifying the regulation adopted in Order No. 636. Similarly, the term-matching cap has never been included in the regulation, but has simply been established as a matter of policy in preamble discussion in Order Nos. 636-A (the 20-year cap) and 636-C (the five-year cap). The Commission also allowed the parties to agree to a cap of a different length. [33]

34. The Commission has required pipelines to implement the ROFR by including provisions in their tariffs governing long-term shippers' ROFR rights. These tariff provisions flesh out the shippers' ROFR rights and the procedures for governing the exercise of the ROFR, which may vary in some respects from pipeline to pipeline. In both the Order No. 636 restructuring proceedings and the filings to narrow the ROFR permitted by Order No. 637-A, the Commission has reviewed the pipelines' proposed ROFR tariff provisions for consistency with Section 284.221(d) and the Commission's various polices concerning the ROFR.

35. In these circumstances, the Commission finds that, once approved, the pipeline's ROFR tariff provisions are part of the pipelines' lawful tariffs filed pursuant to NGA section 4, and therefore must govern the parties' conduct until changed under NGA section 5.[34] When a tariff does not include facets of the Commission's policies or if the tariff is ambiguous on matters of Commission policy pertaining to the ROFR, the tariff should be interpreted as consistent with Commission policy. In Order No. 637-A,

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[32]18 C.F.R. § 284.221(d) (2002).

[33]Order No. 636-B, 61 FERC ¶ 61,272 at 62,026-7.

[34]Arkansas Louisiana Gas Co., 453 U.S. 571, 577-9 (1981). Section 4(d), NGA (a natural gas company shall not make any change in its service unless it files the change 30 days in advance with the Commission); 18 C.F.R. § 154.3 (2002) (a natural gas company must not impose any practice different from those prescribed in its effective tariff on file with the Commission unless otherwise specifically ordered by the Commission).

because the regulation did not specifically state the policy concerning volumetric portions of capacity, the Commission wished to make clear that this right, that is, the right to exercise the ROFR with respect to a volumetric portion of a customer's capacity, applied even if the pipeline's tariff was silent or ambiguous on this issue.

36. However, to the extent an approved, existing ROFR tariff provision is inconsistent or directly contrary to the Commission's regulation or policies, the Commission finds it must change the existing, approved tariff under Section 5 and make the necessary findings under Section 5 that the existing tariff is unjust and unreasonable and that a newly determined tariff is just and reasonable. The Commission has proceeded in this manner in the Algonquin and Texas Eastern proceedings discussed above.

37. In summary, where a pipeline has a tariff that is ambiguous or is silent concerning the ROFR, the Commission will interpret the tariff as in compliance with its regulation. Where a pipeline has a tariff that the Commission has found to be just and reasonable and the tariff currently differs from the regulation in any respect, the tariff determines the scope of the ROFR on that pipeline until the Commission finds the tariff to be unjust and unreasonable under Section 5 of the NGA and determines a new just and reasonable provision under that section.

## III. Backhauls and Forwardhauls to the Same Point

38. In Order No. 637, the Commission also addressed segmentation of capacity, under which shippers may divide their mainline capacity into segments with each mainline segment equal to the contract demand of the original contract. As a general matter, shippers may overlap those mainline segments, but only up to the contract demand of the underlying contract. In Order No. 637-A, the Commission clarified that a shipper using a forwardhaul and backhaul to bring gas to the same delivery point in an amount that exceeds its contract demand is not overlapping mainline capacity. On appeal, the petitioner agreed this segmented transaction does not exceed contracted-for capacity on the mainline, but asserted it does exceed a shipper's contracted-for capacity at the delivery point. The Court found the Commission had not adequately addressed whether this policy modified the contracts between the pipeline and its shippers or adequately supported the need for any contract modification.[35] The Court remanded this issue for further explanation, without reversing or vacating the Commission's holdings.

[35] INGAA at 41.

39. As discussed below, the Commission affirms its policy that a segmented transaction consisting of a backhaul up to contract demand and a forwardhaul up to contract demand to the same point is permitted.

**Background**

40. As indicated above, a forwardhaul and a backhaul to the same point will not exceed contract demand on the mainline. This may be illustrated by the following example:

Example: Fowardhaul and backhaul to the same point

Direction of gas flow ------>

A B C

Assume a shipper has a contract for 100 Dt of firm forwardhaul service from primary receipt point A to primary delivery point C. The shipper schedules 100 Dt to flow from A to B, a secondary point, and the same shipper (or its replacement shipper) seeks also to schedule a segmented backhaul from C to B of 100 Dt. On the mainline, 100 Dt will flow from A to B and be delivered to the shipper at point B. Another 100 Dt will also be delivered to the shipper at B, but this amount will be taken from gas put on the system by someone else. The shipper will restore the 100 Dt to the system at point C. As the shipper will have 0 Dt of capacity moving forward from B to C, that offsets the 100 Dt in backhaul from C to B. Thus, there is no overlap in excess of contract demand on the mainline betwen A and C when the forwardhaul and the backhaul are made to the same point. But as the forwardhaul delivers 100 Dt at B and the backhaul delivers 100 Dt at the same point, for total deliveries at B of 200 Dt, the only question is whether the delivery of 200 Dt should be permitted as being consistent with the principles of segmentation or exceeds contract demand.

41. Order No. 637-A determined that a backhaul and a forwardhaul to the same point do not involve a mainline overlap. Therefore, a shipper may simultaneously schedule forwardhaul and backhaul transactions to the same point, where each transaction

involves deliveries up to the shipper's contact demand on each segment, as in the above example.

42. The Commission has since addressed scheduling priority for reversals of flow, a decision that has implications for forwardhauls and backhauls to the same point A backhaul is usually a reversal of the flow of gas specified in the contract. In Tennessee Gas Pipeline Co.[36] the Commission held that a reversal of flow would be considered outside of the shipper's primary path, because the shipper did not control the mainline capacity when flowing gas in reverse. Therefore, such reverse flow transactions would receive lower scheduling priority than within-the-path transactions under the Commission's within-the-path scheduling policy. Thus, generally, most backhaul transactions will have lower scheduling priority than forwardhaul transactions. The lower scheduling priority for backhauls that are reversals of flow reduces the possibility of operational problems since the backhaul transaction need not be scheduled if there is insufficient capacity at the delivery point. In other words, if point B in the above example did not have sufficient capacity to handle a 200 Dt delivery for the shippers, the backhauls would not be allowed.

**Discussion**

43. As discussed below, the Commission here reaffirms its prior determination that a segmented transaction consisting of a backhaul and a forwardhaul to the same point that exceed a shipper's contract demand at the point is permissible. Marketers, LDCs, electric utilities, and producers, support reaffirming Order No. 637-A's requirement that backhauls and forwardhauls to the same point must be permitted even though contract demand is exceeded. These commentors believe that the Commission's policy does not violate a pipeline's contracts and that it encourages competition and the development of market centers. Pipelines and INGAA believe that backhauls to the same delivery point as used in the forwardhaul transaction which exceed contract demand at the point should not be permitted and that such transactions violate a pipeline's contracts with its shippers.

44. Below, the Commission first concludes that it may implement its policy concerning forwardhauls and backhauls to the same point by acting under NGA section 5 to require pipelines to modify the terms and conditions of service in their tariffs. The Commission need not (and does not) modify the pipelines' individual service agreements with their shippers. Second, the Commission makes the required findings under NGA

[36] 99 FERC ¶ 61,017 at 61,064-65 (2002) (Tennessee).

section 5 to require pipelines to file to make this change in their terms and conditions of service.

**Contract Review**

45. As required by § 154.110 of the Commission's regulations, pipelines must include in their tariffs pro forma service agreements, which set forth the standard contract the pipelines will enter into with all shippers. These pro forma service agreements uniformly include clauses allowing the pipelines to change their rates, rate schedules, and terms of conditions of service by making unilateral filings with the Commission pursuant to NGA section 4.[37] They also contain provisions incorporating the terms and conditions in the pipeline's tariff into the service agreement. In addition, Commission policy, as stated in Order No. 637, prohibits pipelines from negotiating different terms and conditions of service with particular customers than are set forth in their generally applicable tariffs and form of service agreement.[38]

46. Thus, the pipelines' standard service agreements automatically give shippers any increased rights which may be provided by changes in the terms and conditions of service in the pipeline's tariff. Moreover, the Commission reviews these changes pursuant to the just and reasonable standard in sections 4(e) and 5(a) of the NGA, not the more stringent public interest standard set forth in F.P.C v. Sierra Pacific Power Co., 350 U.S. 348, 355 (1956). [39] As the Court stated in INGAA, "[P]ipeline contracts are

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[37]In 1948, with the promulgation by the Federal Power Commission of Order No. 144, pipelines replaced their existing sales contracts with a "tariff-and-service-agreement" system which consisted of an agreement which did not itself contain a price term, but referred to rate schedules of generally applicability on file with the Commission. The new agreements also contained clauses that permitted the pipeline to change its rates and terms and conditions unilaterally. Memphis at 115 n.8. This system has continued to this day.

[38]Order No. 637, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,091, at 31,342-44. Order No. 637-A, FERC Stats. & Regs. Regulations Preambles (July 1996-December 2000) ¶ 31,099, at 31,647-48.

[39]A pipeline's ability to file to make unilateral changes in its contract is controlled by the provisions of the contract. If a pipeline reserves the ability to make changes, as
(continued...)

subject to modification by the Commission on findings that their terms are unjust or unreasonable . . . ."[40]

47. Accordingly, the Commission may require pipelines to permit a forwardhaul and a backhaul, each up to the shipper's mainline contract demand, to the same delivery point by making the necessary findings under NGA section 5 to modify the pipelines' terms and conditions of service so as to permit this. The Commission need not modify any term in the individual service agreements between pipelines and their shippers to accomplish this, since the service agreements incorporate the terms and conditions in the tariff.

48. We recognize, as INGAA points out, that those service agreements typically include a provision that the pipeline will deliver up to the specified contract demand to a primary delivery point (or points) identified in the service agreement. However, that provision only defines the shippers' guaranteed firm right to make deliveries at its primary delivery point. [41] The Commission's policy concerning forwardhauls and backhauls to the same point does not increase the shipper's primary point rights. For example, if the shipper's primary service is a forwardhaul and it schedules a forwardhaul to its primary delivery point and a backhaul to the same point, the backhaul will be considered to use the point on a secondary basis, as described above. To the extent capacity at the point is being fully utilized on a primary basis, the backhaul would not be scheduled. Therefore, the Commission is not requiring pipelines to permit the shipper to use primary point rights beyond those set forth in its contract. Rather, the Commission is providing an additional right for firm shippers to use delivery points on a secondary basis.

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[39](...continued)
the pipelines' form of service agreements do, the pipeline may do so by filing under section 4(d) of the NGA. The just and reasonable standard of review applies to such filings and also to Commission review of these filings under section 5. United Gas Pipe Line Co. v. Memphis Light, Gas and Water Division, 358 U.S. 103, 110-113 (1958) (Memphis); United Gas Pipe Line Company v. Mobile Gas Service Corp., 350 U.S. 332 (1956).

[40] INGAA at 38.

[41] Tennessee Gas Pipeline Co., 94 FERC ¶ 61,097 at 61,402 (2001).

49. The Commission has consistently implemented its polices concerning firm shippers' rights to use points on a secondary basis by acting under NGA section 5 to require pipelines to modify the terms and conditions of their tariff to give such rights to their shippers, and this has not been considered to improperly modify the shippers' individual service agreements. Shippers' secondary delivery point rights originated in Order No. 636. Before Order No. 636, pipeline tariffs and contracts did not permit the use of delivery points other than the primary delivery points listed in the contract. Nor was capacity release or segmentation permitted. However, in Order No. 636, the Commission determined that firm transportation capacity held by shippers should include the same flexibility the pipeline enjoyed when it provided bundled sales service, and the ability to use capacity flexibly, through the use of flexible point rights and segmentation, was part of the flexibility enjoyed by pipelines.[42] Therefore, Order No. 636 required pipelines to modify the terms and conditions in their tariffs to provide for capacity release, flexible point rights,[43] and segmentation.[44] It stated that "flexible receipt and delivery points will promote maximum efficient usage of the pipeline system, are necessary to the development of market centers and to the achieving of a meaningful capacity releasing program."[45] In addition, in Order No. 636-B, the Commission clarified that the general principle that firm shippers should be able to make full use of their pipeline capacity through release transactions applies to backhaul arrangements.[46]

50. As a result of the changes to the pipeline's terms and conditions of service required by Order No. 636, firm shippers were permitted, for the first time, to change their primary points, to use all other points on the portion of the pipeline for which they were paying reservation charges as secondary points, and to engage in segmented transactions. The Commission did not modify the pipeline's individual service agreements in making these changes, nor was it argued that the Commission was

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[42]Order No. 637-A at 31,590.

[43]Flexible point rights applied only to Part 284 open access transportation service. They do not apply to transportation shippers receive under individual Section 7(c) certificates. Order No. 636-A at 30,585.

[44]Order No. 636, ¶ 30,939 at 30,420-21 and 30,428-29; Order No. 636-A, ¶ 30,950 at 30,582-85.

[45]Order No. 636-A at 30,582.

[46]Order No. 636-B, 61 FERC ¶ 61,272 at 61,997 (1992).

required to do so. These policies on segmentation and flexible receipt and delivery points were not challenged in the appeal of Order No. 636. United Distribution Companies v. FERC, 88 F.3d 1105 (D.C. Cir. 1996 (UDC).

51. In Order No. 637, the Commission again found that segmentation increases the number of capacity alternatives and so improves competition and facilitates the development of market centers. Because it was not clear that all pipelines were in compliance with the Commission's Order No. 636 policy to permit segmentation, the Commission, in Order No. 637, included the right to segment capacity in its regulations, making a generic finding that pipelines that can permit segmentation operationally but do not are acting in an unjust and unreasonable manner.[47] Segmentation includes flexible point rights for shippers because segmentation must be combined with flexible point rights in order to create effective competition between pipeline services and released capacity[48] and also to permit a shipper to make the most effective use of its own capacity.[49] In INGAA, the Court affirmed both segmentation and flexible point rights as continuations of policies adopted in Order No. 636.[50] Again, the Commission has implemented the segmentation and flexible point rights requirements of Order No. 637 by requiring the pipeline to modify the terms and conditions of service in its tariff to provide for these rights.

52. Even apart from the issue of forwardhauls and backhauls to the same point, the Commission's policies concerning flexible point rights and segmentation have expanded shippers' point rights beyond those expressly set forth in their service agreements, including allowing shippers to make total deliveries in excess of the mainline contract demand stated in their service agreements. For example, in segmented transactions in

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[47]Order No. 637-A at 31,590-91; Order No. 637-B at 61,164-65. Because pipelines may have to implement segmentation in different ways depending on the operational characteristics of their systems, the Commission then required all pipelines to file their tariffs, with revisions if necessary, to determine whether any individual pipeline tariffs were unjust and unreasonable with regard to segmentation. The Commission made revisions to individual pipeline tariffs under section 5 of the NGA in the individual Order No. 637 compliance filings.

[48]Order No. 637-A at 31,594.

[49]Order No. 637-B, 92 FERC ¶ 61,062 at 61,166 (2000).

[50]INGAA at 39-40.

which there are several forwardhauls to different points, a shipper is able to make deliveries at each delivery point up to its contract demand. Thus, a shipper with a contract demand of 100 Dt from point A to point C could segment its capacity and transport 100 Dt from A to a secondary point at B and another 100 Dt from B to the primary delivery point at C. It would use delivery point rights in this transaction of 200 Dt, an amount in excess of its mainline contract demand of 100 Dt.

53. Nevertheless, as described above, this expansion of shippers' point rights has been accomplished solely through section 5 action to modify the pipelines' general terms and conditions of service. Since the customers' individual contracts with the pipeline provide for the customer to receive the service set forth in the terms and conditions of the tariff, as those terms may be changed from time to time, it has not been necessary to change the individual contracts, nor has the Commission done so. The Commission concludes that it may similarly require pipelines to permit backhauls and forwardhauls to the same point, each of which is up to the shipper's contract demand, by making the necessary findings under NGA section 5 to require the pipeline to revise its terms and conditions of service to permit this.

**Section 5 Findings**

54. The Commission makes the necessary findings under section 5 as follows. The Commission determined in Order No. 637 that failure to permit segmentation is unjust and unreasonable. A backhaul and a forwardhaul to the same point which exceed a shipper's maximum contract demand at the point is a type of segmented transaction. Failure to permit such a segmented transaction where operationally feasible is unjust and unreasonable because it restricts efficient use of capacity without adequate justification.[51] Permitting this type of transaction is just and reasonable because it creates additional supply alternatives for shippers and enhances competition on the pipeline's system.

55. Also, under Order No. 636, the firm transportation capacity held by shippers was to include the same flexibility the pipeline enjoyed when it provided bundled sales service, and the ability to use capacity flexibly, through the use of flexible point rights and segmentation, was part of the flexibility enjoyed by pipelines.[52] Pipelines could forwardhaul and backhaul gas to the same delivery point when they performed bundled sales service, and therefore shippers should have that flexibility today. The issue is not

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[51]See Order No. 637 at 31,304; Order No. 637-A at 31,591.

[52]Order No. 637-A at 31,590.

so much whether forwardhauls and backhauls to the same point can, or will, occur. Rather, the issue is whether these transactions may be accomplished through the sale of segmented capacity by the firm shippers who have paid for that capacity, or whether they can only be accomplished if the pipeline makes a direct sale of its capacity in at least one transaction. The Commission implemented flexible point rights, capacity release, and segmentation at least in part to create more competition in the transportation market, including competition between capacity release and the pipeline's sale of interruptible and short-term firm service, and giving the shipper the opportunity to engage in forwardhauls and backhauls to the same point is consistent with that goal.

56. INGAA contends that shippers are getting more than the capacity for which they pay if they are permitted to have a backhaul and a forwardhaul to the same point, both up to contract demand. However, the shipper must pay for a portion or a zone on a pipeline regardless of the actual length of its haul. It is the Commission's policy that a shipper may use all of the points in a zone for which it is paying on a secondary basis precisely because the shipper must pay the costs of the entire zone. The general principle that firm shippers should be able to make full use of their pipeline capacity specifically applies to backhaul arrangements in capacity releases[53] and to other segmented transactions. The shipper is getting no more than what it pays for. The pipeline, for its part, has fully allocated its costs and is collecting those costs from its shippers. If this type of segmented transaction should cause a decrease in IT or short-term firm transportation that the pipeline can sell, then the pipeline is permitted to file a new rate case in which more of its costs would be allocated to firm service.

57. The ability to use mainline capacity to deliver gas to the same point also does not lead to the shipper exceeding its mainline contract demand and the Commission expressly overturns any such contrary interpretation in its Letter Order in Iroquois Gas Transmission System, L.P.[54] The underlying principle of segmentation, as adopted in Order No. 637, is that a shipper can use its mainline capacity flexibly so long as it does not exceed the contract capacity on the mainline, regardless of how much gas it takes off the system in total. As with a segmented transaction consisting of two forwardhauls, a segmented transaction consisting of a backhaul and a forwardhaul to the same point does not exceed the shipper's mainline capacity at any point, since as shown in the example at the start of this section these two transaction do not lead to gas flows anywhere on the mainline in excess of the shipper's contract demand.

[53] Order No. 636-B, 61 FERC ¶ 61,272 at 61,997 (1992).

[54] 78 FERC ¶ 61,135 at 61,523-24 (1997).

58. Therefore, the Commission finds under section 5 of the NGA that permitting segmented transactions consisting of a backhaul and a forwardhaul to the same point that exceed contract demand at the point is just and reasonable. Pipelines must permit these transactions to the extent they are operationally feasible. Pipelines that the Commission has found must permit segmentation on their systems must file, within 30 days of the date of this order, revised tariff sheets to expressly permit segmented transactions consisting of forwardhauls up to contract demand and backhauls up to contract demand to the same point at the same time. That is, the revised tariffs must provide that a shipper (or a releasing shipper and a replacement shipper) may segment its capacity by simultaneously transporting its full contract demand in a forwardhaul and its full contract demand in a backhaul to the same point. The Commission will take section 5 action on these filings.

59. In sum, the Commission affirms its prior holding that shippers may make a segmented transaction consisting of a backhaul and a forwardhaul to the same point, and the Commission requires pipelines to modify their terms and conditions of service in order to ensure that shippers have this right.

## IV. <u>Waiver and Condition of Posting and Bidding for LDCs</u>

60. The Court reversed and remanded Order No. 637 on an issue concerning the posting of prearranged short-term capacity releases for bidding while the price cap for these transactions was removed. As explained below, the price cap has been reinstated, so that posting is no longer required for these transactions and waiver and conditions for waiver of posting are moot.

61. Before Order No. 637, the Commission provided that releasing shippers need not post prearranged deals at the maximum rate for bidding. However, Order No. 637 waived the maximum rate for capacity releases of less than one year until September 30, 2002. The Commission therefore found that all prearranged releases of less than one year must be posted for bidding. The Commission, however, stated that in individual cases where a local distribution company (LDC) considers an exemption from the posting and bidding requirement essential to further a state retail unbundling program, the LDC, together with the appropriate state regulatory agency, could request the Commission to waive the posting and bidding requirement. The Commission also stated

that if the LDC requests such a waiver, the LDC must be prepared to have all its capacity release transactions limited to the applicable maximum rate for pipeline capacity.[55]

62. The Court found that the Commission failed to support its rule conditioning the waiver of posting and bidding requirements on limiting all of the LDC's capacity release transactions to the applicable maximum rate. The Court accordingly reversed the Commission on this issue and remanded for the Commission to review the matter and reframe the waiver conditions.[56]

63. The price cap for short-term releases was reestablished on September 30, 2002. Once again, prearranged releases of less than one year at the maximum rate need not be posted for bidding. Consequently, LDCs are not required to post short-term releases at the maximum rate and the issues of waiver of the posting requirements and conditions on the waiver are moot.

The Commission orders:

(A) The Commission's responses to the issues on remand are as set forth in the body of this order.

(B) Within thirty days of the date of this order, pipelines that the Commission has found must permit segmentation on their systems must file revised tariff sheets to expressly permit segmented transactions consisting of forwardhauls up to contract demand and backhauls up to contract demand to the same point at the same time.

By the Commission. Commissioner Breathitt dissenting in part with a separate statement attached.

( S E A L )

Linwood A. Watson, Jr.,
Deputy Secretary.

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[55]Order No. 637-A at 31,569.

[56]INGAA at 62-63.

UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Regulation of Short-Term Natural Gas Transportation Services and Regulation of Interstate Natural Gas Transportation Services

Docket No. RM98-10-011

(Issued October 31, 2002)

Linda K. Breathitt, Commissioner, dissenting in part:

I agree with most of the order. However, I will be dissenting again on the majority's decision to permit forwardhauls and backhauls to the same delivery point in excess of a shipper's contract demand.

The D.C. Circuit remanded the issue to the Commission because we had not adequately explained why allowing forwardhauls and backhauls to the same delivery point in excess of contract demand is not an unlawful contract modification.

The order states that the Commission is making the necessary section 5 findings to modify pipelines' tariffs to permit forwardhauls and backhauls to the same point. The order states that it need not modify any term in an individual service agreement between pipelines and their shippers to accomplish this, since service agreements incorporate the terms and conditions in their tariffs.

I do not believe that the issue is as clear cut as stated by the order. Contractual rights and obligations are the foundation of the relationship between pipelines and their shippers and are the underlying basis for filings before this Commission. Delivery point rights are an important aspect of the contractual relationship. The order recognizes that the Commission is providing an additional right for firm shippers to use delivery points on a secondary basis. While I support increased flexibility for shippers, I do not believe that it is just and reasonable to expand shippers' contractual rights without the corresponding cost responsibility. I do not believe the majority has fully addressed that issue here. I therefore respectfully dissent in part.

Linda K. Breathitt
Commissioner