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NATURAL GAS AND THE FEDERAL ENERGY REGULATORY COMMISSION

Kenneth A. Williams*

I. INTRODUCTION

As I am sure you have heard discussed in the last couple of days, on August 4, 1977, the Department of Energy Organization Act¹ was passed by Congress and signed by the President. In the Organization Act, an independent regulatory commission was established to be called the Federal Energy Regulatory Commission.² Henceforth, I will refer to it as FERC. It is commonly considered and frequently referred to as an extension or continuation of the Federal Power Commission (FPC), but in actuality, the FPC ceased to exist on September 30, 1977. The Federal Energy Regulatory Commission commenced operations on October 1, 1977.

II. FERC AUTHORITY

In order to help you understand what the Federal Energy Regulatory Commission does, I thought I would point out very briefly that in the transition there were certain functions previously conducted or performed by the FPC that were transferred to FERC, which related to both electric and gas matters. On the electric side, the FERC will continue to issue permits and licenses with regard to hydroelectric projects; it will continue to regulate rates and charges, acquisitions of securities, authorizations for interlocking directorates, and mergers and disposition of property.³ On the gas side, the FERC assumed the responsibil-

* Deputy Director, Office of Pipeline and Producer Regulation, Federal Energy Regulatory Commission; B.A. Western Kentucky University.

1. Department of Energy Organization Act of 1977, Pub. L. No. 95-91, 91 Stat. 565, (to be codified at 42 U.S.C. §§ 7101-7352).

2. *Id.* at §§ 401-407, 91 Stat. 582-87 (to be codified at 42 U.S.C. §§ 7171-7177).

3. 16 U.S.C. §§ 792-828(c) (1976).

ity for the regulation of producer and gatherer rates, the rates and charges levied by interstate gas pipeline companies, the certification of facilities, the certification of abandonments of facilities and service, and the establishment and enforcement of curtailments on natural gas pipeline systems.⁴

In addition to assuming the responsibility for these functions, certain other functions were specifically assigned from FERC to other departments within the Department of Energy. One of these was the establishment and review of priorities for natural gas curtailments. As I said before, the FERC does have the responsibility for establishment and enforcement of curtailments. But the responsibility for the establishment and review of priorities was transferred to the Secretary of the Department of Energy. Another function that was specifically assigned to another part of the Department was the regulation of imports and exports of both electricity and natural gas.⁵ In addition to the functions that were transferred from the FPC and transferred to and away from FERC, the Commission assumed certain new responsibilities.

One of them is the rate regulation of oil pipeline companies, and the conduct of valuations of oil pipeline companies.⁶ Another is the consideration of energy actions by the Secretary under certain circumstances. Also the Commission was given the responsibility for reviewing proposals by the Secretary with regard to proposed rules, regulations, and statements of policy that might affect the jurisdiction or responsibilities of FERC. FERC also has certain responsibilities with regard to remedial orders of the Department of Energy, as well as denials of requests for adjustments by the Secretary. This briefly establishes what the current responsibilities are. I would like to turn to some of the areas where major problems exist today. It should be recognized that the FPC over the years was confronted with, or was beleaguered by, very difficult problems, most of which transferred over to the FERC.

III. GAS SUPPLY AND THE DUAL MARKET

The question of gas supply, and the response to the gas supply shortage, was one of the problems that the FPC faced and wrestled

4. 15 U.S.C. §§ 717-717(w) (1976).

5. Department of Energy Organization Act of 1977, Pub. L. No. 95-91, 91 Stat. 583 (to be codified at 42 U.S.C. § 7172(f)).

6. *Id.* (to be codified at § 7172(b)).

with for a number of years.⁷ By way of demonstrating what our situation is today, as of the end of 1976, according to American Gas Association data, our proven gas reserves totalled about 216 trillion cubic feet. This was a continuation in the decline of proven reserves which began in 1968,⁸ and it continues a trend in the significant difference between what we are producing and consuming and what we are adding in the way of new reserves. By way of demonstrating this, in 1976 we produced 19.5 trillion cubic feet and we added 7.6 trillion cubic feet. With that type of differential, we are going to continue to have declining natural gas reserves.

Another matter that has been of major importance to the FPC and now FERC is the fact that even with the continuing decline in new reserves added, a smaller and smaller portion of those reserves has been dedicated to interstate commerce.⁹ This is particularly troublesome to a federal agency; it might be less troublesome to state and local jurisdictions. For example, in 1976, of the 7.6 trillion cubic feet added, only 2.8 were dedicated to interstate commerce. This is roughly thirty-seven percent. I might point out this is a much greater percentage than had occurred in any previous year since 1973. The percentages had been much smaller, and of course before 1973 the percentages were larger. They were in the sixty to seventy percent range.

So we have a declining gas supply situation. We have the tendency to dedicate gas to the intrastate market in lieu of the interstate market. We have a trend toward the drilling of developmental wells rather than exploratory wells. I would like to point out that in 1976 there were substantially more total wells drilled than in 1975. In the first three quarters of 1977, the same trend continued. There were more wells drilled in 1977 than in 1976. On the other hand, the ratio of developmental wells has continued to be high relative to the total number of wells drilled. Obviously under this circumstance we are adding very little additional proven reserves. It is not difficult to understand why under today's dual market system, it is advantageous and

7. Comment, *Natural Gas Rate Regulation: The Conflict in the Application of the Just and Reasonable Standard*, 12 TULSA L.J. 293 (1977).

8. See FPC, A STAFF REPORT ON NATIONAL GAS SUPPLY AND DEMAND (1969). Nineteen sixty-eight was the first year that production and consumption of natural gas exceeded the amount added to reserves through exploration and recalculation of present gas fields. In simple terms, it signaled that unless the ratio changed toward more reserves, the U.S. would run out of gas.

9. There are two distinct natural gas markets. The *intrastate* market is regulated and includes only the gas which is produced, transported and consumed in one state. The *interstate* market is regulated and includes all gas that crosses state lines. Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941 (1973) [hereinafter cited as Breyer & MacAvoy].

even economic to drill developmental wells in lieu of exploratory wells. There is a less risk; there is more assurance of recovering investments.

It is not difficult to understand why gas is being dedicated to the intra, versus the interstate, market under the regulated, versus unregulated, situation that exists. So we have in the natural gas supply situation declining total natural gas proven reserves, a tendency to drill developmental wells, and a propensity to dedicate the gas to the intra versus the interstate market. I would like to point out that this is addressed primarily to onshore gas reserves. When one looks at the National Energy Plan¹⁰ as proposed by the administration, there are clear indications that these conditions were recognized and the plan sets out to correct some or perhaps all of them.

Under the National Energy Plan, the criteria for establishing eligibility for new gas prices were designed to encourage the drilling of exploratory wells; to the extent that developmental wells were drilled, these wells would generally not get the higher price. The National Energy Plan proposed by the administration would eliminate the differential, at least insofar as new wells are concerned, between the prices that gas could be sold for in the inter and intrastate markets,¹¹ and by doing so might encourage some of the gas to go into interstate commerce. This obviously depends upon the market circumstances, buyer circumstances, and the location of the particular production relative to existing pipeline facilities.

As most of you know, the FPC, after the *Phillips*¹² decision in 1954 where it was told to regulate independent producers selling gas for resale in interstate commerce, attempted to perform that regulation on a company-by-company basis. It became completely bogged down because of the number of companies, and the difficulties in reviewing the books and records of each company.¹³ The Commission then went to an area rate approach, in which it attempted to establish just and reasonable rates for different areas of the country.¹⁴ In Opinion Nos.

10. EXECUTIVE OFFICE OF THE PRESIDENT ENERGY POLICY AND PLANNING, NATIONAL ENERGY PLAN (1977).

11. *Id.* at 53.

12. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

13. The size and complexity of the task literally overwhelmed the FPC's administrative process; some 2,900 applications for individual rate determinations were received between 1954 and 1962. Processing the application of the Phillips Company alone took 82 days, filled 10,626 pages with testimony and involved 235 exhibits. C. HASKINS, *THE FIELD PRICE REGULATION OF NATURAL GAS* 37 (1969); Breyer & MacAvoy, *supra* note 9, at 954.

14. *Permian Basin Area Rate Proceeding*, 34 F.P.C. 159 (1965). See generally Mosburg, *The Permian Decision—A Study in Group Regulation*, 19 OKLA. L. REV. 133 (1965).

699¹⁵ and 770,¹⁶ the Commission went to a nationwide rate approach in which the FPC established just and reasonable rates to be applicable on a nationwide basis. One of the characteristics of the Commission's Opinion 770, attempting to relate costs to production, was to employ the spud date for establishing eligibility for new gas prices. I think it can be said that even this spud date approach provides an incentive for people to drill developmental wells in lieu of exploratory wells.

With the National Energy Plan now before Congress, the FERC has chosen to defer further proceedings to determine general producer pricing until there is some type of action or indication of action by the Congress. If a National Energy Act is ultimately passed, it may not be necessary to go through another rate proceeding. On the other hand, if some action is not forthcoming, then the Commission will be faced with the task of developing new just and reasonable rates under the Natural Gas Act.¹⁷

IV. CURTAILMENTS OF NATURAL GAS

We are all aware of some of the problems and difficulties that we have encountered, and that the nation has encountered as a result of the gas supply shortage. The most visible problem and the one which we are the most aware of is the natural gas curtailments, which includes curtailments imposed by natural gas pipelines and curtailments imposed by distributors upon their markets. After 1968 the FPC recognized that there was a growing natural gas shortage¹⁸ and in April 1971, the Commission issued an order, designated Order No. 431, in which it advised pipeline companies to take all actions necessary to assure reliable and adequate service to their markets. The Commission also instructed pipelines expecting to be unable to provide such service to file curtailment plans to be included in their tariffs. In 1973, the Commission issued Order No. 467-B,¹⁹ which detailed the Commission's policy with regard to priorities of service. The Commission assigned the highest priority to residential and small commercial use, and the lowest priority to boiler fuel. There were nine priority categories with the intermediate categories depending upon the use of the gas, the ability to use alternate fuels, and the size of the requirements themselves.

15. 18 C.F.R. § 2562 (1976).

16. 41 Fed. Reg. 50,199 (1976).

17. 15 U.S.C. § 717c (1976).

18. FPC, STAFF REPORT NO. 2, NATIONAL GAS SUPPLY AND DEMAND 1971-1990 (1972).

19. 49 F.P.C. 583 (1973).

Today, most interstate pipeline companies have in effect and operate under some form of curtailment plan. Some of these plans have been approved by the FPC or the FERC on a permanent basis. At least one has been imposed by the courts, and others are in effect on an interim basis pending final determination by the Commission.

A. *Curtailment Process*

Each year the Commission requires two reports from the pipeline companies as to what each company expects in the way of availability of supplies and its projected curtailment for the coming heating season as well as the next twelve months. In September of 1977, the pipeline companies projected on an over-all basis, curtailments for this winter heating season amounting to roughly twenty percent. On an annual basis, they projected average curtailments of roughly twenty-five percent. Some pipeline companies projected curtailments as high as forty-seven percent for this heating season. I think it is important to recognize that there are wide variations in the levels of curtailment on individual pipeline systems. Some are curtailing very little, and when I talk of curtailment I am speaking in terms of curtailment of firm requirements generally determined upon customers requirements for some base period.

Once the information is gathered on the projected curtailments, companies that are projecting potential levels of curtailment that could result in plant shutdowns or potential injury to life or property are identified. Those companies are then called in and are the subject of further review. This winter we conducted an intensive review of six pipeline companies to determine exactly what their individual circumstances were, what had been done, what their options were, and how we could avoid adverse impact both on the pipeline companies and the markets they serve.

It should also be pointed out that in our proceedings involving the individual pipeline companies, where we do pursue their situation in detail, we work very closely with the Economic Regulatory Administration and rely upon their data on the availability of alternate fuels. Where there is an indication of potential industrial shutdown, or where there is an indication of gas not being available for certain industrial applications, our concern is with the availability of alternate fuels.

As most of you know, curtailments have posed some serious difficulties for all of us. The pipeline companies recognize that curtailments have resulted in reduced throughput, and have created serious

cost allocation problems. The availability of unused capacity on many of the pipeline systems raises questions as to where the burden of the costs associated with this capacity should fall. As a result of declining supplies and the investment still remaining in many pipeline facilities, the consumer has been exposed to higher unit costs for natural gas service. One of the most troublesome questions now facing FERC is what to do about load growth. On many pipeline systems, even though the pipelines are themselves in substantial curtailment, individual distributors are able to add loads because of the availability of alternate fuels, and the availability of alternate sources of supply, such as synthetic natural gas or liquid natural gas, storage or even local intrastate supplies. The Commission is faced with the question of whether, at this time and under circumstances of curtailment, pipeline company operations should be changed so as to have the effect of making gas available and encouraging, or making possible, load growth, particularly of high priority loads. Obviously, there are considerations with regard to the reliability of service, both at present and over time, the potential for increasing curtailment to everyone down the road and when that will occur, and the operations and economic consequences of requiring low priority users to shift to alternate fuels. These are serious problems that the Commission faces not only as a matter of policy, but as immediate issues in a series of cases. These issues are before the Commission in both curtailment cases and in certificate proposals to expand storage.

B. *Compensation and Curtailments*

Another problem that has been with us for most of the time that curtailments have been with us, but which has become more difficult with time, is the question of compensation. Where distributors and end users have developed their operations in reliance on natural gas service, but under implementation of curtailment plans they no longer are able to receive that service, the question has been raised as to whether low priority consumers should be compensated to offset the cost of using alternate fuels by those other consumers continuing to receive gas service. The FPC in a series of cases had held that this constituted a sale, and that it could not legally require, nor was it disposed to implement, a compensation scheme in curtailment plans. The courts have advised the Commission that it is not legally prohibited

from implementing a compensation scheme,²⁰ and on November 30, 1977, the Commission issued a preliminary notice of rulemaking in which it required parties to respond both as to the criteria and methodology for the development of an equitable compensation plan. The Commission recognizes it has the difficult task first of determining if an equitable compensation scheme can be developed, and if so, how it can be applied.

Another area associated with curtailments that presents a developing problem is the increased reliance upon emergency purchases. Under section 7 of the Natural Gas Act,²¹ the Commission, although it cannot exempt sales for resale, does have the authority not to require certificate authority for actions taken under emergency conditions. In order to avoid difficulties on individual pipeline systems and the markets they service, the Commission has permitted pipeline companies to make emergency purchases and to flow the gas and the costs through to the ultimate consumer. Some very difficult questions have arisen. First of all, should those volumes be purchased specifically for particular end users who are in emergency situations? If so, how should they be made available? Assuming that the gas is purchased for system supply, how should the costs be recovered? Last winter (1976-1977), the nation experienced a very difficult time²² and Congress passed the Emergency National Gas Act of 1977.²³ In the legislation it appeared that the emergency purchases would be for particular users who would receive the gas and would bear the costs.

In a series of orders, the FPC attempted to implement that approach, but ultimately found that there was so much opposition and that there was sufficient question as to the legislative intent, that the emergency gas and the costs associated therewith were flowed through on the basis of the effective curtailment plans that the individual pipeline companies were utilizing at the time. Consequently, the emergency gas was not purchased, made available and priced on the basis of

20. See generally, *Fort Pierce Utility Authority v. F.P.C.*, 526 F.2d 993 (5th Cir. 1976); *Mississippi Power & Light Co. v. United Gas Pipeline*, 532 F.2d 412 (5th Cir. 1976); Note, *Liability of Natural Gas Pipeline Companies for Breach of Contract Due to FPC—Ordered Curtailment*, 1973 DUKE L.J. 867.

21. 15 U.S.C. § 717 (f) (1976).

22. While the effects of the winter of 1976-1977 cannot be fully assessed, it is clear that the severe cold weather coupled with the gas shortage caused a major disaster. There were 75 weather-related deaths and the economics of 17 eastern states were seriously affected with over 2 million persons laid off from work. [1977] EN USERS REP. (BNA), No. 181, at 4-5, [1977] EN USERS REP. (BNA), No. 182, at 6-7; WALL ST. J., Feb. 1, 1977 at 1, Col. 3.

23. Pub. L. No. 95-2, 91 Stat. 4 (1977).

which customers and consumers benefitted from the availability of the gas.

These are two of the problem areas. I won't go into such matters as the Alaska Gas Project, where the Commission, the President and the Congress have selected a successful applicant and the matter is now back before FERC with regard to what kind of project should be certificated, how it should be designed, how it should be financed and what tariff provisions should be applicable. This is a major case that will require a substantial expenditure of time and effort by the Commission over a long period of time.

V. REGULATION OF OIL PIPELINES

I would like to talk about one new area that the FERC assumed under the Organization Act—that being the oil pipeline regulation. This is an area where those of us who were with the FPC had no prior experience or knowledge. From records provided to us from the Interstate Commerce Commission, there are roughly 110 oil pipeline companies that are subject to our jurisdiction. These oil pipeline companies file in the neighborhood of three to four thousand tariff filings a year. We are required to conduct valuations annually on roughly ninety of these pipeline companies and publish these valuations. In the transfer of the responsibility for the oil pipeline regulation, we received at least two cases that I think I should mention to you. One is the *Ex Parte* 308²⁴ case where the I.C.C. had originally instituted an investigation into the continued appropriateness of its methodology for determining valuations for oil pipelines.

Perhaps more important, and certainly more difficult, is the Trans-Alaska Pipeline Case, which was called the TAPS case. This case has been phased, and we are now in the process of cross examination in phase one, which has to do with rate return, rate base, and tax treatment. We will go through the cross examination of the company witnesses. Staff will subsequently serve its case, which will then be cross examined and we will proceed into phase two. In Phase 2 staff will conduct its own investigation and make recommendations as to the cost that the companies should be allowed to recover.

The I.C.C. utilized boards for much of its regulation of oil pipelines, and there were roughly six boards that the I.C.C. utilized for pur-

24. *Ex parte* No. 308, Valuation of Common Carrier Pipelines (decision pending in the Department of Energy).

poses of oil pipeline regulation. On February 10, 1978, the FERC established an employee board, which will perform the functions that these I.C.C. boards performed with regard to oil pipelines. I would like to point out that since this is a responsibility that we very recently received, we will continue to follow the I.C.C. practices and procedures until we have fully evaluated those procedures and made our own determinations. We may develop our own practices and procedures, but it is too early to say if and when this may happen.

VI. CONCLUSION

I have tried to touch briefly upon just some of the major problems before the FERC. They are difficult problems. Under the Department of Energy Act, we now have a more coordinated effort, at least in the federal government, with regard to approaching some of these problems, but I should point out that we are an independent regulatory commission, and so the opportunity to rely upon other parts of D.O.E. is somewhat limited. We can take advantage of the expertise of the Administrator of the Economic Regulatory Administration. We can take advantage of the data-gathering authority of the Energy Information Administration, and we can utilize the research and development expertise of the Department of Energy. Hopefully through the coordinated efforts of these different segments, we can be a much more effective independent regulatory commission, and hopefully with passage of the National Energy Plan, we can solve some of the problems that have been plaguing us for so long, and the solutions to which are so important to all of us.