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Order No. 451--Market-Based Pricing for Old Gas

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ORDER NO. 451—MARKET-BASED PRICING FOR "OLD" GAS*

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I. INTRODUCTION

In the recent furor over the remand of Order No. 436[1] and the Federal Energy Regulatory Commission's (Commission) efforts to patch the open-access program in Order No. 500,[2] Order No. 451,[3] issued on June 18, 1986, has been placed on the back burner. It continues to cook quietly away, however, preparing for an all-out battle over its validity and reasonableness in the United States Court of Appeals for the Fifth Circuit. This battle will continue to explode, as distribution companies, pipelines, and consumer representatives launch a determined attack upon Order No. 451 (Order). Producers will generally support the Commission in defending the Order, while objecting to a few of its facets.

II. THE COMMISSION'S EVOLVING MARKET PRICING PLAN

Order No. 451 is a basic and integral part of the Commission's new plan of regulation for the gas industry, ranking with the open-access transportation program of the *Felmont* case[4] and the abandonment

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1. Order No. 436, F.E.R.C. Stats. & Regs. ¶ 30,665, 50 Fed. Reg. 42,408 (1985).

2. Order No. 500, III F.E.R.C. Stats. & Regs. ¶ 30,761, 52 Fed. Reg. 30,334 (1987) (to be codified at 18 C.F.R. pts. 2 & 284).

3. Order No. 451, III F.E.R.C. Stats. & Regs. ¶ 30,701, 51 Fed. Reg. 22,168 (1986).

4. Felmont Oil Corp. & Essex Offshore, Inc., 32 Fed. Energy Reg. Comm'n Rep. (CCH) ¶ 63,071 (1985), *rev'd and remanded*, Consolidated Edison Co. v. F.E.R.C., 823 F.2d 630 (D.C. Cir. 1987), *on remand*, 42 Fed. Energy Reg. Comm'n Rep. (CCH) ¶ 61,172 (1988). Order No. 436 "open access" regulations have been vacated by the D.C. Circuit court. *See* Foster Natural Gas Report (Foster Associates) No. 1630, at 1-4 (July 30, 1987). Order No. 500 is an interim response to the court's concerns. Order No. 500, III F.E.R.C. Stats. & Reg. ¶ 30,761 at 30,775-76, 52 Fed. Reg. at 30,335.

Notice of Proposed Rulemaking[5] as major foundation stones of the program. Like the Wicked Witch of the West, the take-or-pay problem, otherwise known as the gas inventory or contract restructuring problem, casts a heavy shadow over the entire edifice. In the author's view, the basic structure is sound economic policy and sustainable under the present statutes which the Commission administers.

The new plan is under heavy attack by defenders of the status quo, who benefit substantially from the previous system of regulation or basically distrust the uncertainties inherent in the new system. Like the Court's direction in *Brown v. Board of Education*,[6] the all deliberate speed, with which the Commission is proceeding, seems lightning fast to some and glacially slow to others.

Although the deliberate speed approach followed by the Commission seems slow and ineffective to economic purists, the approach is fundamentally sound and is slowly making its way through the barrage of criticism levelled against it by parties in all sectors of industry and government.[7] After several more years of judicial review, policy statements, and pipeline rate cases, the strategy should emerge in somewhat the following form:

(1) Multiple vintage pricing of the fungible commodity, natural gas, will be gradually phased out, leaving spot market or short-term contracts and longer-term contracts with adjustable pricing provisions that follow the market.

(2) Direct sales will increase between producers and local distribution companies or industrial customers, eliminating or reducing the role of the pipeline as the middleman wholesaler of gas.

(3) Pipelines will separate the transportation and marketing functions of their businesses. The marketing function will be taken over by an affiliate or carried as a separate profit center. Some pipelines will get out of the merchant business entirely, serving only as transporters of gas. The pipeline's monopoly power over transportation will no longer be used to advance its merchant function.

(4) Local distribution companies and state commissions in consuming states will be forced to base distribution company rate structures more on

5. *Abandonment of Sales and Purchases of Natural Gas under Expired, Terminated, or Modified Contracts*, F.E.R.C. Stats. & Regs. ¶ 32,441, 52 Fed. Reg. 18,703 (1987).

6. 347 U.S. 483 (1954).

7. *See* Shoneman & McConnell, *FERC Order No. 451: Freedom (Almost) For Old Gas*, 7 ENERGY L.J. 299, 326-32 (1986).

an economic basis and less on a political basis—that is, subsidies for residential consumers will decrease.
(5) Consumers will be able to base demand projections on more realistic price premises, and producers will be able to make exploration and development decisions on a more realistic basis.
(6) The boom and bust cycle of prices and shortage/surpluses will gradually disappear, as peaks and valleys become less divergent and the sine-curve flattens as the market becomes more effective.

All of this sounds like an economist's dream of Utopia. Yet the basic building blocks of (1) open-access transportation, (2) market-based pricing, and (3) free abandonment are already in place at the Commission level. Unless the difficulties of contract restructuring (the take-or-pay problem) become insurmountable, other problems seem capable of solution. However, the solutions will not be easy—they involve the transfer of potential assets and liabilities amounting to many billions of dollars.

Order No. 451 is the Commission's major effort to have a direct impact upon the pricing system for natural gas. The Commission's objective is known: to have the price for natural gas at every step of its journey from wellhead to burner-tip determined by workable competition in the market place.

III. A Changing Natural Gas Industry

Since the enactment of the Natural Gas Act (NGA)[8] in 1938 and the decision in *Phillips Petroleum Co. v. Wisconsin*[9] in 1954, the gas industry has undergone many changes. These changes are so massive in scope, so gradual in impact, and so contrary to the American public's perception of the industry that many still cannot believe they have occurred. The major changes are:
(1) The elimination of the gas inventory or backlog discovered prior to 1960. In 1960, proved natural gas reserves were estimated at 262 Tcf. In 1987, these reserves had been depleted to 187.2 Tcf.
(2) The construction of the pipeline network or "grid," currently capable of supplying gas to all markets in the nation, often through several different routes.

8. Natural Gas Act, ch. 556, 52 Stat. 821 (1938) (codified as amended at 15 U.S.C. §§ 717-717z (1982)).
9. 347 U.S. 672 (1954).

(3) The recognition that gas does not stand alone as a separate, irreplaceable energy source which must be hoarded against future shortages. Instead, it competes at the burner-tip with conservation measures and alternate fuels such as electricity, fuel oil, coal, and nuclear power, depending upon the market, location, and environmental concerns.
(4) The recognition that, in economists' terms, gas prices are elastic on both the supply and demand side—that is, price has a direct and substantial (although time-lagged) impact upon both supply and demand.

A. *Effects on Vintage Pricing*

As these truths became accepted in industrial and governmental circles, several conclusions became apparent. By interfering with market processes, government price regulation of natural gas adversely affected the consumer and the producer of natural gas:
(1) Vintage pricing, created by the Commission beginning in 1960[10] and expanded by the Natural Gas Policy Act of 1978 (NGPA),[11] was basically incompatible with market pricing.
(2) Vintage pricing caused cross-subsidies between groups of producers, between pipelines, and between groups of consumers, making a national market for gas impossible or unworkable.
(3) Vintage pricing distorted market signals and caused producers to drill unprofitable high-cost wells, seeking prices permitted by law but unrealizable in the market. Vintage pricing also caused great anguish for consumers by driving prices up despite a surplus of deliverable gas.
(4) Attempts to preserve low prices for consumers committed to price-controlled fields are illusory, as these fields are continually depleting and supplies are being replaced with higher-cost gas, forcing burner-tip prices to rise.

B. *Effects on Contract Pricing*

When most "new" gas was decontrolled on January 1, 1985,[12] the wellhead price for gas went *down*, not up, as consumer advocates had erroneously predicted. This decrease proved beyond question to all but

10. Statement of General Policy No. 61-1, Sept. 28, 1960, 25 Fed. Reg. 9578 (Oct. 5, 1960). *See also* Mobil Oil Corp. v. FPC, 417 U.S. 283, 304 (1974); Wisconsin v. FPC, 373 U.S. 294 (1963); Shell Oil Co. v. FPC, 520 F.2d 1061, 1065-66 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976).
11. Natural Gas Policy Act of 1978, Pub. L. No. 95-621, 92 Stat. 3351-411 (codified at 15 U.S.C. §§ 3301-3432 (1982 & Supp. IV 1986)).
12. 15 U.S.C. § 3331(a) (1982 & Supp. IV 1986).

the most prejudiced observers that the wellhead price for gas was workably competitive. The contract prices for gas had reflected the vintage pricing system set out in the statute like a mirror image. When the legal mold holding these prices in place was shattered by deregulation, contracts began to reflect market pressures, and prices declined from a weighted average of about $2.60 per MMBtu in 1984 to $1.83 per MMBtu in the summer of 1988.[13] This adjustment took many forms: (1) lower prices for newly-contracted gas; (2) the use of market-out provisions to reduce prices in existing contracts; and (3) renegotiation of contracts by producers and pipelines to reflect current market prices. These adjustments were sometimes accompanied by buy-out and buy-down payments by the pipelines and release of the gas on a limited term or permanent basis for resale by the producer in other markets.

Except for a few pipelines which refused to comply with their contracts or allowed astronomical take-or-pay balances to build while following a least-cost purchasing strategy to maintain market share, the take-or-pay obligations of interstate pipelines stayed within manageable proportions until the summer of 1986. At that time, the *partial* operation of Order No. 436 open-access transportation—coupled with large quantities of gas released from long-term contracts and sold on the spot market, a sharp drop in crude oil prices, and an accompanying drop in fuel oil prices—caused increases in pipeline take-or-pay obligations, even though some $25 billion of these obligations were settled by pipelines through March 22, 1989.[14]

The major impediment to the renegotiation of pipeline/producer contracts was the fact that only *high-priced* contracts (which were deregulated as to price) were available for renegotiation. Low-priced contracts, covering gas still subject to price ceilings fixed by the Commission prior to 1978, could not be included in the negotiation process. Few producers were willing to negotiate their high-priced contracts *down* to market levels, while still selling gas from other fields at prices substantially *below* market levels, due to price controls. By raising the ceiling price on all of these categories of price-controlled gas, the Commission

13. Foster Natural Gas Report (Foster Associates) No. 1674, at 12 (June 2, 1988).

14. *Hearings on FERC Fiscal Year 1990 Budget Policies Before the Subcomm. on Energy and Power of the House Comm. on Energy and Commerce*, 101st Cong., 1st Sess., 135 CONG. REC. D 259 (daily ed. Mar. 22, 1989) (statements of Martha O. Hesse, Chairman of the Federal Energy Regulatory Commission and Charles Trabandt, Commissioner of the Federal Energy Regulatory Commission).

allowed (but did not require) these contracts to be brought to the bargaining table.

IV. ORDER NO. 451

In examining Order No. 451, the abolition of vintaging by the collapse of the lower-price vintages into the highest ceiling price which existed pre-NGPA, and the accompanying good faith negotiation rule, students often bog down in the mechanics. The basic concepts of Order No. 451 are really quite simple:

(1) Establish a *ceiling* price at the estimated *cost of replacing* the gas being produced under current conditions.

(2) Establish a market price for each sale by allowing the producer and pipeline to renegotiate the terms of the sale, regardless of the price set out in the contract (provided the contract price exceeds the determined market price) but not allowing that price to exceed the replacement cost ceiling.

A. *Specific Objectives*

Since the onset of area ceiling prices in the mid-1960's, producers in the interstate market have been subject to a *double* ceiling price—the first being the price set out in the negotiated contract and the second determined by the Commission, with the producer collecting the *lower* of the two. Order No. 451 retains this concept, with two major changes. The first change is that the cost calculation used by the Commission to determine the ceiling price turned out to be *higher* (not lower, as had always previously been the case) than the market price. Under prior law, the area rate clause[15] of the contract would automatically allow collection of the new ceiling price. Often, this allowance would make a large portion of the gas completely unmarketable and politically unacceptable to captive customers. Had the Commission adopted this approach, there is no doubt that Congress would have reimposed price control legislation in a matter of months. Indeed, within a week after Order No. 451 was issued, the Senate considered a bill which would have denied funding for implementation of the Order. This bill failed by *only one vote* because of the perception that all contract prices would rise to the ceiling.

15. An area rate clause provides for periodic adjustment to the highest price that is allowed in the area by the appropriate regulatory body. Lowe, *Gas Contracting: The Lessons of the Seventies* (no. 4), 3 NAT. RESOURCES & ENV'T 3, 6 (ABA Section of Natural Resources Law 1989).

As a result, the Department of Energy (DOE) in its proposal[16] and the Commission in enlarged form adopted the famous (or infamous, depending on your viewpoint) good faith negotiation rule. The purpose of this rule was to allow the pipeline purchaser to renegotiate the contract covering price-controlled gas down to market levels, which varied between pipelines and producing areas, *even though the producer already had contract authority* to collect the ceiling price. If the pipeline and producer could not agree on what the market price was, the gas could be released at the request of either party and resold by the producer to other purchasers. In this way, global settlements between pipelines and producers could occur, as *all* the contracts were now on the table, not just the high-priced ones. The pipeline, at its option, could retain the supply by paying the market price or choose to relieve its overbought condition by releasing the gas.

B. *Glitches and Gremlins*

Most of the criticism directed at Order No. 451 from the producer and pipeline sectors has been against the good faith negotiation procedure.[17] Many producers started from the legally sound, but politically unacceptable, position that since their area rate clauses gave them authority to collect the ceiling price and the Commission had raised the ceiling price, they could collect it, *period.* The good faith negotiation rule was therefore attacked as an abrogation of contracts, second bite at the apple for the pipelines, etc. Pipelines, on the other hand, with gas inventory problems always uppermost in their minds, saw the good faith negotiation procedure as a means to force, seduce, persuade, or cajole the producers into renegotiation of high-priced contracts in exchange for raising lower-priced contracts. Consequently, the pipelines' weighted average cost of gas (WACOG)[18] would be affected as little as possible by the Order.

1. Balancing of Interests

The Commission modified the DOE proposal to make concessions

16. Order No. 451, III F.E.R.C. Stats. & Regs. ¶ 30,701 at 30,199-200, 51 Fed. Reg. at 22,169.

17. Shoneman & McConnell, *supra* note 7, at 326-28.

18. Pipelines will generally purchase gas from various fields and wells at different prices. The pipeline averages these prices, weighted by volume, to arrive at a weighted average price of gas (WACOG). Thus, not only will this number vary from pipeline to pipeline, it will also constantly change within each pipeline as existing stores are depleted and new supplies are purchased. Johnson, *Gas Marketing—An Industry in Transition*, 30 ROCKY MTN. MIN. L. INST. 12-1, 12-10 -11 (1984).

to each position, to the satisfaction of neither party. To placate the pipelines whose WACOG would be adversely affected by the rise in ceiling prices, the Commission provided that not only the lower-priced, controlled-gas categories of gas could be renegotiated, but *also* other categories of gas covered by the same contract as the lower-priced gas (multivintage contracts). Even categories which had been deregulated were now subject to the renegotiation process. This much had been in the DOE proposal. The Commission then took a *second* step and provided that *any other contract* between *that* producer and *that* pipeline which contained *some* old NGA gas was also on the table for renegotiation. This reflected the pipelines' persistent argument that despite market trends, some producers continued to insist upon performance under their old contracts, which many pipelines found to be not only repulsive, but life-threatening. The second step also implemented the Commission's long-standing policy of encouraging, in every way possible, the restructuring of contracts based on the vintage pricing system to a market-sensitive system.

But then the Commission gave the producer a weapon—the good faith negotiation procedure could not start *unless the producer* chose to begin the process. If the producer was content with the status quo, which included no change in the pre-NGPA ceiling prices for old gas, except for inflation adjustments, the producer could stay with it, and nothing changed.

Predictably, the pipelines attacked the Order No. 451 good faith negotiation procedure because it did not place *all* contracts on the table (whether the Commission had jurisdiction to do so or not) and demanded the right to institute the procedure, objecting to the provision that only the producer could start the dance. Producers, on the other hand, wanted to limit the good faith negotiation rule to old, price-controlled NGA gas, allowing it to rise to the market price but not affecting any other categories of gas, particularly categories in contracts *other* than those categories the producer chose to bring to the table.

The Commission's middle ground probably turned out to be a wise choice. Although still questioned by some, the better view appears to be that contracts which contain *some* NGA gas can condition the price increase for that gas on possible price decreases in other categories of gas covered by the same contract. On the other hand, the Commission does *not* have jurisdiction to force the producer to bring to the bargaining table contracts with *no* NGA gas, even as a condition to collecting ceiling prices on NGA gas under other contracts. Thus, the Commission has probably reached the limits of its jurisdiction in the Order No. 451 compromise. It will force renegotiation of gas in as many contracts as it can to market levels, driving prices both up and down.

2. Demand for Release and Troublesome Requirements

Once the renegotiation process begins, the club in the hand of either party is to demand release of the gas for resale to third parties when the other party is unwilling to agree to the market price. This option relieves the pipeline's oversupply situation but usually at the expense of an increase in its WACOG, as the released gas is in the lower-priced category. It also throws out an old shibboleth, deeply embedded in the minds of many old-line distribution companies, that they have a *vested right* in the old price-controlled gas connected to their pipeline systems.[19]

Finally, the problem of transportation of the released gas must be addressed. Release of gas from the contract, even when coupled with abandonment authority under section 7(b) by the Commission,[20] is of little avail to the producer unless the producer can also be assured of transportation of the gas to the nearest interconnection with other pipeline systems. Here the Commission relied on its "voluntariness" theory, requiring that where gas is released at the instigation of either party, the pipeline must agree to transport either to the former customers of the gas or to an interconnecting pipeline. The transportation requirement is separate and apart from the "open-access" provisions of Order No. 436[21] and does not apply to a pipeline which has elected to become an "open-access" transporter under that order. If, as a result of Order No. 500, interstate pipelines become Order No. 436 transporters, the separate transportation provisions of Order No. 451 will become moot.

The Order No. 451 transportation plan has, from the producer's viewpoint, a severe glitch. Some distribution companies still follow the policy of strongly opposing any attempts on the part of their pipeline suppliers to relieve their oversupply situation by releasing old, price-controlled gas, which they regard as their property and seek to conserve for the future even though they are unwilling or unable to buy it now. Consequently, the Commission imposed two requirements upon a release

19. Order No. 451, III F.E.R.C. Stats. & Regs. ¶ 30,701 at 30,235-36, 51 Fed. Reg. at 22,194-95.

20. 15 U.S.C. § 717f(b) (1982).

21. For a detailed discussion of Order No. 436 pipeline transportation regulations, see Pierce, *Reconstituting the Natural Gas Industry from Wellhead to Burnertip*, 9 ENERGY L.J. 1, 24-27 (1988).

sought by the producer. First, the producer must present a firm offer to purchase the gas to be released from a third-party purchaser before the pipeline is required to release the gas. Additionally, the pipeline itself must reject the time and price offers made by the third party purchaser. Second, former purchasers from a non-436 pipeline have the right of first refusal to meet the third party's offer within thirty days. The pipeline must furnish a list of its customers to the producer, who must give these parties thirty days' notice of the terms of the third-party offer. However, the producer may pick one or several of the pipeline's former customers to receive the gas at the third party's offered price; it is not required to prorate the sale among them. Any customer exercising this right is entitled to transportation by the releasing pipeline *over the full pipeline system* to the point at which the customer previously purchased gas from the pipeline itself. Third-party purchasers are entitled to transportation only to the point of interconnection with another pipeline.[22]

The mandatory transportation provisions and the right of first refusal retained by the original pipeline customers are two of the most controversial portions of Order No. 451. The right of first refusal flies in the face of the national free market for gas, which is the driving force behind the Order as well as the Commission's blanket abandonment policies in the *Felmont* doctrine.[23] This provision is the primary issue to be raised by producers upon court review.

C. *Court Review*

The court review of Order No. 451 has been delayed because of a vigorous procedural battle between producers and pipelines/distributors/state commissions (pipelines) over which of the courts of appeals should have venue to review the decision. After a split-second race to the courthouse and voluminous pleadings, the Fifth Circuit Court of Appeals finally issued its famous "toss-of-the-coin" ruling, after finding all other factors impinging on the venue issue to be equal. The producers won the toss, and the case is currently being reviewed in the Fifth Circuit.[24] Subsequently, the pipelines group came up with another gambit—they sought to divide the case on an "issue" (the issues to be selected by them) basis, with separate joint briefs on each designated "issue." This strategy would enable distributor and pipeline groups to combine on an

22. Order No. 451, III F.E.R.C. Stats. & Regs. ¶ 30,701 at 30,255, 51 Fed. Reg. at 22,209.
23. *See supra* note 4.
24. Mobil Oil Exploration Co. v. FERC, 814 F.2d 998 (5th Cir. 1987).

"issue" basis, thus allowing them to file briefs three to four times as long as would otherwise be permitted by the court's rules. Producers objected, and this issue is still in doubt.[25] Once the procedural questions are resolved, there will be three substantive issues before the court.

1. Just and Reasonable Pricing

The major attack levied upon Order No. 451 by the distribution companies and state commissions will be to question the Commission's authority and record support for its increase in the just and reasonable ceiling prices for thirteen categories of "old" gas into the fourteenth or highest-priced category, thus eliminating the "vintage price" concept. Although Congress clearly gave the Commission the power to increase the ceiling prices for sections 104 and 106 gas,[26] the increase must be based upon a Commission finding that the higher-ceiling prices are "just and reasonable." Reaching back into the history of pre-NGPA area and national ceiling price cases, the distributors contend that the "just and reasonable" ceiling price for "old" or "flowing" gas was always determined by the Commission on the basis of a calculation of the "historic" cost of finding and producing gas. This "historic" cost basis calculation would probably not generate a ceiling price of more than fifty cents per MMBtu and might be as low as twenty-five cents per MMBtu, depending upon the adjustments made.

The Commission rejected the theory that it must rely upon historical cost calculations to determine the ceiling price for sections 104 and 106 gas. These calculations would have required a massive new data collection effort, and the Commission found, for sound economic reasons, that this methodology would not lead to a realistic result today. Moreover, such a method would lead to a ceiling price which (like the pre-Order No. 451 pricing structure) would result in the waste of trillions of cubic feet of gas in old, cheap, discovered, pipeline-connected reservoirs due to premature abandonment of existing wells. Instead, the Commission adopted the theory of basing the ceiling price upon "replacement cost," or the cost of replacing the sections 104 and 106 gas[27] being produced under current conditions. Its choice of "replacement cost" over

25. On April 22, 1988 the Fifth Circuit rejected the concept of "issue" briefs, but enlarged the page count beyond that normally permitted by the court's rules. Order, Mobil Oil Exploration Co. v. FERC, 814 F.2d 998 (5th Cir. 1987) (No. 86-4940).

26. 15 U.S.C. §§ 3316(c), 3314(b)(2) (1982).

27. 15 U.S.C. §§ 3314, 3316(b) (1982).

"original cost" is one already granted to it by Fifth Circuit court precedent in *Tenneco Oil Co. v. Federal Energy Regulatory Commission*.[28] The model for calculating replacement cost is also well-established by court precedent. This was the procedure utilized by the pre-NGPA Commissions in establishing ceiling prices for "new" gas in Opinions 699-H[29] and 770-A,[30] affirmed by the courts in *Shell Oil Co. v. Federal Power Commission*[31] and *American Public Gas Association v. Federal Power Commission*.[32]

For record evidence to support its conclusion, the Commission looked first to its replacement cost study in Opinion 770-A, which had built-in adjustment factors to account for inflation since the issuance of the opinion, arriving at the ceiling price of $2.57 per MMBtu as of June 1986. The producers filed an in-depth cost study updating each of the factors considered in the Order No. 770-A cost calculation, arriving at a ceiling price of $2.77 per MMBtu. The Commission picked the lower figure in order to "protect consumers against potential inaccuracies in the Indicated Producers' updated estimate"[33] even though the Commission conceded that the producers' estimate was probably more accurate.

2. The Take-or-Pay Problem

As in every major Commission proceeding since 1984, the pipelines and distribution companies attacked Order No. 451 as exacerbating their take-or-pay problems, by allowing additional quantities of cheap, released gas into the market. The pipelines and distribution companies argued that this allowance made it even more difficult for them to sell pipeline supplies at their WACOG, even though Order No. 451 itself provides pipelines with substantial opportunities for dealing with their gas inventory problems. The pipelines' solution is to: (1) allow them to institute the negotiation process as a condition for raising ceiling prices; and (2) include all contracts, whether deregulated or not, and all categories of gas in the good faith negotiation procedure. This would allow the pipelines to escape, arbitrarily and without compensation to the producer, the market risk which they assumed when the contracts were

28. 571 F.2d 834, 840 (5th Cir.), *cert. dismissed*, 439 U.S. 801 (1978).
29. 52 F.P.C. 1604 (1974).
30. 56 F.P.C. 2698 (1976).
31. 520 F.2d 1061 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976).
32. 567 F.2d 1016 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 907 (1978).
33. III F.E.R.C. Stats. & Regs., REGULATIONS PREAMBLES ¶ 30,229 (1982-85).

signed.[34] Some pipelines, particularly those having access to the old Panhandle-Hugoton Field, contend that the good faith negotiation procedure will change their WACOGs so drastically that their financial security will be endangered.

At the time Order No. 451 was issued, the Commission contended that even though it was *raising* the ceiling prices, the market forces unleashed by the good faith negotiation procedure would actually force wellhead prices down. This claim was met with scorn and disbelief by the distributor and consumer communities. Since Order No. 451 was issued, however, this is precisely what has occurred. The weighted average wellhead price for the lower forty-eight states in the United States, which stood at $2.76 in December 1984,[35] dropped to $1.60 in July 1987.[36] While other causes certainly must be considered, there is no question that Order No. 451 played a significant part in the price drop. Indeed, producers have been slow to seek the Order No. 451 ceiling prices except in the context of global pipeline settlements, as the current spot price for gas ($1.35 to $1.90 per MMBtu)[37] lies at about the midpoint of the pre-NGPA, pre-Order No. 451 pricing structure. So, without even considering deregulated gas, renegotiation of pre-NGPA gas prices may result in as many downward as upward price changes.

3. The Ritual Mating Dance

Most of the early discussions of Order No. 451 involved a detailed walk-through of the mating dance of the whooping crane, as the good faith negotiation procedure has sometimes been called. As this is about as exciting as watching grass grow, that discussion will not be pursued here. There is a copy of the regulations in the Appendix below so that the winding path can be followed step by step, should anyone have the need or desire to do so.

V. CONCLUSION

The purpose of this article has been to develop a basic understanding of the Commission's objectives in Order No. 451 and to put this Order into its proper place in the Commission's overall plan to implement a

34. Universal Resources Corp. v. Panhandle E. PipeLine Co., 813 F.2d 77 (5th Cir. 1987).
35. 51 Fed. Reg. 22,195 (1986).
36. Foster Natural Gas Report (Foster Associates) No. 1669, at 31 (Apr. 25, 1988).
37. Foster Natural Gas Report (Foster Associates) No. 1708, at 3 (Feb. 2, 1989).

national, free, market-based pricing scheme for gas. Perhaps this may help readers to keep their eyes on the doughnut and not on the hole!

APPENDIX: MECHANICS OF THE GOOD FAITH NEGOTIATION RULE[38]

(1) Prerequisite—contract authority (includes area rate clause) to increase price to new ceiling price (sections 104 and 106).

(2) First Step—the producer "requests" the purchaser to nominate a new price for section 104 or 106 gas;

(a) If the producer is content with the status quo, the producer does not make this request and nothing happens under Order No. 451 (despite the contract right to collect the new ceiling price).

(b) Consequences of making a "first step request":

(i) The pipeline may nominate full contract price (under an area rate clause this would be the ceiling price), and the sale continues at the new higher (ceiling and contract) price;

(ii) the pipeline may nominate "market" price at some price level below ceiling price;

(iii) the producer can select certain "vintages" under the contract or certain contracts and limit "request" to those vintages or those certain contracts, *but*

—other vintages in the same contract are no longer subject to the Good Faith Negotiation rule *if this option is instigated by the producer*, and

—the producer must accept *all* of the pipeline nomination or it is deemed to be a rejection.

(c) If the purchaser does not respond to a "first step" request by a producer within sixty days, the producer can sell the gas to a third party and abandon the sale to the original purchaser on thirty days' notice;

(i) If the purchaser is *not* an Order 436 transporter, the producer must give a "right of first refusal" to firm sales customers of the initial purchaser:

—The purchaser must supply a list of firm sales customers as of the date the new contract is signed by the producer;

—The producer is *not* required to honor the right of first refusal on a *pro rata* basis but can select one or more firm sales customers of the initial purchaser;

—If none of the firm sales customers elect to exercise the right of first refusal, the sale to the third party is firm, and the right of first refusal is gone forever and is *not* recreated when the third party contract expires.

(ii) The producer gets automatic abandonment—a blanket certificate to make new interstate commerce sales with pregranted abandonment and no Commission review of changes.

(3) Second Step—request by the producer creates the following

38. Order No. 451, III F.E.R.C. Stats. & Regs. ¶ 30,701 at 30,250-58, 51 Fed. Reg. at 22,204-09.

rights *in the purchaser* (exercisable within thirty days of producer's request):

(a) The purchaser can "request" the producer to nominate a price for vintages nominated by the producer *and any other gas covered by the same contract*;

(b) In addition, the purchaser can "request" the producer to nominate a price for any gas *under any other contract with the same producer* which includes *some* old (price-controlled) gas or any vintage covered by such contract;

(c) Where another contract covers *only* "new" (deregulated) gas, the purchaser *cannot* request nomination;

(d) The purchaser must accept or reject the nominated price made by the producer within thirty days. If the purchaser accepts the nominated price, the sale continues at that price—rejection or acceptance must be of all the gas under one contract—the purchaser can accept or reject on a contract-by-contract basis;

(e) If the purchaser rejects the producer's nominated price, it can discontinue purchases of some or all wells *at any time thereafter* upon thirty days' notice.

(4) Third Step—the producer can request the purchaser to nominate a price for other vintages of gas in additional contracts brought to the table by the pipeline within thirty days of the purchaser's request. The producer can also request nomination of a price by the purchaser as to the same vintages requested by the pipeline in Step Two:

(a) If such request is not made within thirty days, the producer loses its right to make such a request;

(b) The purchaser's nomination must be made within sixty days of the producer's request;

(c) The producer has thirty days to accept or reject the nominated price, and if accepted, the sale continues at that price;

(d) If the producer rejects the nominated price, the producer can sell to a new purchaser, subject to a right of first refusal in existing firm customers of an existing purchaser which is not an Order 436 pipeline. There are no requirements as to the price or terms of the new contract. Until the new purchaser is found and for thirty days thereafter, the producer must continue the sale to the existing purchaser at the existing contract price;

(e) Release and abandonment procedures are the same as in Step One.