Implications of Open Access for Natural Gas Markets

WILLIAM F. HEDERMAN, JR.

In October 1985, the Federal Energy Regulatory Commission issued a new rule that was intended to create a new natural gas marketplace based on open-access nondiscriminatory natural gas transportation. However, that rule, Order 436, failed to resolve all the issues adequately. Because of these unresolved issues, change has been troublesome and the transition to open-access transportation has not been completed. Described in this paper are the changes that have taken place, the key issues that remain unresolved, and the important new issues emerging as Order 436 is implemented.

The following paragraphs provide some background for those not familiar with the natural gas aspect of the energy business. The natural gas industry has been buffeted by federal regulation for decades. Wellhead price controls created the supply shortages of the mid-1970s and Congress responded with the Natural Gas Policy Act of 1978 (NGPA).

The NGPA improved the supply situation but also generated forces unanticipated at its time of passage. These forces put gas suppliers in competition with suppliers of other fuels and then in competition among themselves. When combined with factors such as soft petroleum prices, a serious surplus of deliverability for the interstate natural gas market resulted. This competition has yielded some important benefits to gas users in terms of lower gas prices. Industrial consumers, however, have voiced loud objections because they are dissatisfied with the pace of price decreases.

Pipeline companies traditionally operated as wholesale merchants of gas operating under regulations that set their rates and established service obligations to their sales customers. To meet their service obligations, they signed long-term contracts with their suppliers. Not surprisingly, during severe supply shortages when some pipelines were being sued by customers for failure to meet service obligations, there was great pressure to bid on whatever supplies were available. Federal regulated prices—intended to be ceilings—served as the floor prices producers would accept, and bidding took place through nonprice terms of the contracts. These nonmarket responsive contracts have seriously hindered pipelines in adjusting to the radically new gas marketplace.

Congress, concerned about the market disorders still troubling natural gas markets, has attempted, unsuccessfully, to pass new, comprehensive natural gas legislation. Federal gas regulators at the Federal Energy Regulatory Commission (FERC) have imposed several important new rules that are intended to address these same market distortions. These rules have released pipeline customers from their contractual obligations and have released pipeline suppliers of low-cost gas from their low, regulated prices. The FERC has also attempted to coerce pipelines to open access to their systems. Implementation of open access has proved difficult. The key to unlocking the interstate natural gas transportation system is the establishment of a policy framework that fairly shares the costs and rewards of shifting from a closed to an open-access system; from a sale-for-resale system burdened with long-term contract problems to a transportation system.

Interstate Natural Gas Association of America, 1660 L St., N.W., Washington, D.C. 20036. Current affiliation: ICF, Inc., 9300 Lee Highway, Fairfax, Va. 22031.

ALTERNATIVES FOR PIPELINES

Policymakers concluded that opening pipelines to transport gas owned by parties other than pipelines would help solve the problem of getting market signals from the burner tip to the wellhead. An overview of the various options that have been explored as ways for interstate pipelines to respond to current market conditions is shown in Figure 1. Traditional, full merchant service is indicated in the lower right-hand corner of this matrix; heavy regulation with all services (gas purchase, brokering, transporting, storing, load balancing, etc.) are shown bundled together. In the upper left-hand corner voluntary carriage as an example of a less-regulated, unbundled, one-service option is shown. In between are many alternatives that could vary with the extent of regulation or the extent of services that are bundled together.

Through Order 436, however, the FERC has locked the pipeline into the heavily regulated band of this matrix. As indicated in the figure, unbundling subject to heavy regulation is largely unexplored terrain. Regulated unbundled services, therefore, are a new development. This change could mean new opportunities—and new risks—for pipeline customers, pipeline suppliers, and of course, for pipelines themselves.

KEY ISSUES

As already mentioned, the road to open-access transportation has been a rocky one. Much of this difficulty may be attributed to the failure of federal policymakers to address two crucial issues: *(a)* the contracts problem, and *(b)* gas supply planning. This failure by FERC is creating a leadership void in the natural gas industry, especially in gas supply planning.

Contracts Problems and Transportation

The supply contracts problems that pipelines have with their natural gas suppliers remain the key hindrance to more open-

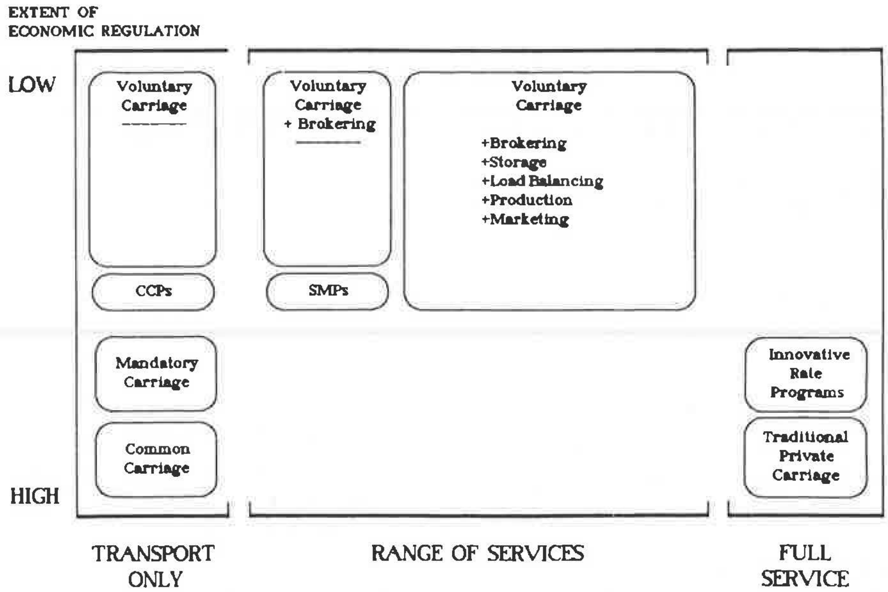

FIGURE 1 Alternative business structures for pipelines.

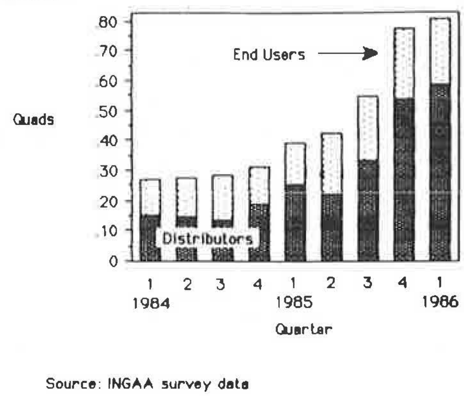

FIGURE 2 Carriage for distributors and end users.

access transportation. The cumulative impact of FERC's actions has been to lay a take-or-pay burden on the pipelines. Not only has the FERC abrogated pipeline contracts with customers through Order 380, it has also taken away the only lever pipelines had to encourage producers holding problem contracts to renegotiate—the power to control access to their systems.

The member companies of the Interstate Natural Gas Association of America (INGAA) reported more than $9 billion in take-or-pay exposure at the end of 1985. They predict additional exposure of more than $6 billion for 1986 alone. In the context of roughly $25 billion of equity in the interstate pipeline business, the extent of the problem can be appreciated. Pipelines have been troubled by this issue for several years now, but the problem is not diminishing. Even the producers' figures show that post-settlement take-or-pay grew by 75 percent in 1985. Pipeline concern about take-or-pay is, if anything, growing. The House Government Operations Committee has demonstrated sound judgment in its continuing efforts to persuade the FERC to take a realistic approach toward a fair resolution of take-or-pay and related contract problems.

INGAA keeps a close watch on interstate transportation activity, and the evidence demonstrates that pipelines are, in general, seriously committed to transporting gas for others. The latest statistics show transportation for distributors and end users in the first two quarters after Order 436 was implemented was more than double the level for the same period a year earlier (Figure 2). Transportation for distributors and end users is now almost one-quarter of interstate pipeline deliveries to market.

Supply Planning

The second crucial area in which federal regulators have fallen short is in gas supply planning. Somebody needs to take responsibility to assure reliable gas supplies. FERC rules are used as a means to persuade pipelines to shed their merchant role and transport gas only. The administration, and to some extent the courts, are encouraging similar changes. In the past, pipelines have served to arrange supplies without receiving any markup on purchased gas prices. Profits have come from transporting gas.

Many at the FERC seem to believe that the market will assure supplies in the future. In the long run, it is expected that the market will balance demand and supply. As a noted economist once said, however, "In the long run, we're all dead." As the events of recent months have shown so dramatically, energy market circumstances can experience radical changes very quickly. The kind of price runup that a seriously cold winter could create in conjunction with supply difficulties resulting from the current depressed exploration and development activity would, most likely, not be viewed as serving the public interest.

Establishing accountability for the gas supply planning function is of immediate and critical importance. When the home owner, hospital, or school authorities turn up the thermostat, the gas must be there. It must be made clear where the responsibility lies.

Federal policy has failed to assign responsibility. Fortunately, some state regulators have realized the dangerous gap in supply planning created by FERC's stance. Some states are considering including local utility forecasts and long-term supply strategies in their oversight review of distributor operations. Hopefully, pipelines, their local distribution company (LDC) customers, and state regulators can agree on new pipeline service obligations as merchant and transporter. Such agreement, and the establishment of corresponding obligations for customers to their suppliers, should go a long way toward achieving the benefits of a more competitive marketplace and provide a framework for arranging future gas supply availability.

State Regulation

The previous two issues are of longstanding importance in the natural gas industry. One that has emerged recently is that the importance of state level regulation for natural gas is increasing dramatically. State regulation will play an increasingly crucial role in the success or failure of the new natural gas marketplace. State regulators approve the rates most users see; they will determine the extent to which competitive forces extend beyond the city gate, and they will set the supply planning requirements for LDCs.

The executive committee of the National Association of Regulatory Utility Commissioners (NARUC) recently passed a resolution urging the establishment of a joint federal-state board with FERC. This action by NARUC is a welcome sign of leadership on the part of state regulators to fill the void created by FERC's laissez faire policies on natural gas supply planning, take-or-pay, and other crucial issues.

Settlements

Many of INGAA's member companies are now in the process of negotiating with their customers. The object of these negotiations is to develop workable transitions from the traditional full-service world, in which pipelines are merchants, selling wholesale gas, to a world in which pipeline customers—for better or worse—take control of their destinies. In the absence of workable federal guidelines, settlements appear to provide one remaining option for developing a fair sharing of the costs and responsibilities of the transition to open-access transportation. Through these negotiations, pipelines hope to establish mutually acceptable conditions under which they can open their systems to transportation while protecting the interests of their remaining sales customers and their stockholders. If the FERC would approve all pending filings and settlements, INGAA's tally indicates that about 85 percent of the interstate market would be open to nondiscriminatory access.

At the present time, there appears to be some reluctance on the part of LDCs and most state regulatory bodies to encourage the pipelines to shed their merchant role. Many pipeline LDC customers want pipelines to retain the major responsibility for acquiring and managing gas supply, as has been done in the past.

This is the role the pipelines have always played and are willing to continue to play, provided there is a clear definition of where the responsibilities lie.

CONCLUSION

Despite the shortcomings of current natural gas regulations, achieving a fair resolution of remaining transition problems is in everyone's interest. Natural gas now needs open access to remain effectively competitive; but pipelines cannot be left holding the bag for nonmarket responsive contracts from an era of intrusive federal regulation that seriously distorted normal contracting options.

Federal policymakers have not succeeded in developing a framework to promote a smooth transition. Pipelines and their customers are seriously negotiating to find a mutually acceptable way to reach open access. Other parties, including state regulators, pipeline competitors, and industrial end users are actively involved in the struggle. Hopefully, this effort can lead to a resolution of remaining problems on a case-by-case basis. With the leadership of state regulators and a willingness on the part of others to move beyond these current problems, natural gas should be able to retain its role as an important domestic energy source.

Publication of this paper sponsored by Committee on Pipeline Transportation.