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FERC Revises Pipeline Capacity Release Rules

"This final rule will strengthen competition in the secondary capacity release market, and therefore benefit consumers, by giving shippers more options for how they obtain gas supplies and improving access to the interstate natural gas pipeline system. The rule also will provide more accurate price signals on the market value of pipeline capacity."

FERC Chairman Joseph T. Kelliher

On June 19, 2008, in Order No. 712, *Promotion of a More Efficient Capacity Release Market*, Order No. 712, 123 FERC ¶ 61,286 (2008), FERC issued major modifications to its regulations governing the release by shippers of firm capacity held on interstate natural gas pipelines. These changes will potentially affect all participants in the secondary market for pipeline capacity — not simply gas marketers, but also any electric utility that owns gas-fired generation units.

Releasing shippers now will be in a position to earn increased revenue on many capacity release transactions. For that reason, firm capacity holders on particular pipelines also may be more likely in the first instance to release unneeded capacity. In addition, the new rules should facilitate capacity release transactions made in conjunction with asset management arrangements.

Elimination of the Rate Cap on Releases of One Year or Less

FERC's pipeline capacity release rules allow firm capacity holders to release capacity into the secondary market. The capacity is posted for bidding on the relevant pipeline's electronic bulletin board (EBB) and is awarded in full to the highest bidder meeting all the conditions of the release (or proportionally in the case of a tie). Where the releasing shipper enters into a capacity release agreement with a predesignated replacement shipper, the predesignated replacement shipper receives all the capacity, *provided* it meets the highest competing bid.

With the exception of an experimental period between early 2000 and late 2002, a shipper could not release firm pipeline capacity to a replacement shipper at a price in excess of the relevant pipeline's maximum rate. The cap applied regardless of the willingness of potential replacement shippers to pay the "excess" price.

FERC has now determined, however, that the rate cap interferes with efficient capacity allocation. At the same time, FERC believes that the existence of rate caps on primary pipeline capacity (both firm and interruptible) will prevent releasing shippers from exercising market power in secondary markets — at least in the short term. Order No. 712 thus eliminates the rate cap on capacity releases of one year or less (short-term releases). The cap remains on releases in excess of one year.

In addition to the impact on releasing shippers' revenues, lifting the cap on short-term releases will have important practical consequences. As mentioned, a releasing shipper has the right to designate a prearranged replacement shipper that is guaranteed the capacity if it meets the highest bid. In the past, because of the rate cap, FERC exempted prearranged releases at the maximum rate from *pre-release* posting on the pipeline's EBB. The pipeline had to post the release after the fact for informational purposes, but by definition there was no need for bidding on a release at the maximum rate.

With the rate cap on short-term releases now eliminated all prearranged releases for one year or less, with certain exceptions, must be posted in advance for competitive bidding. A designated replacement shipper in a prearranged release will still have the option to meet competing bids. But in the case of a short-term release, the designated replacement shipper no longer can lock in a guaranteed maximum rate. Prearranged releases at the maximum tariff rate for periods in excess of one year remain exempt from the bidding requirement.

The previous capacity release regulations exempted from the bidding requirement any release of 31 days or less. Order No. 712 retains that exemption. Shippers should be cautioned, however, that Order No. 712 also retains the prohibition against "rolling over" such releases at the expiration of 31 days without making the capacity available for bidding. In addition, Order No. 712 retains the requirement that a releasing shipper may not re-release capacity for 31 days or less to the same replacement shipper at less than the maximum tariff rate without competitive bidding until 28 days after the first release has expired.[1]

The second exemption from bidding requirements involves capacity releases undertaken in conjunction with asset management arrangements, which will be discussed below.

Asset Management Arrangements

When FERC first promulgated its capacity release regulations in the early 1990s, the agency's focus was on regulating capacity brokering. In other words, FERC sought to regulate the methods by which capacity holders sold unneeded capacity into the secondary market. However, FERC did not foresee another aspect of capacity release — that owners of gas-fired generation or local gas distribution companies would seek to release capacity to asset managers in conjunction with asset management arrangements (AMAs). In Order No. 712, FERC recognizes the benefits of AMAs and that those benefits can be frustrated by the existing capacity release rules. Accordingly, FERC promulgates certain exemptions applicable only for capacity released to an asset manager.

A release eligible for these AMA exemptions is any prearranged release that contains a condition that the releasing shipper may, on any day during a minimum period of five months out of each 12-month period of the release, call upon the replacement shipper (*i.e.*, the asset manager) to:

(i) deliver to the releasing shipper a volume of gas up to 100 percent of the daily contract demand of the released transportation capacity or

(ii) purchase a volume of gas up to the daily contract demand of the released transportation capacity.

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1 Because Order No. 712 eliminates the cap on *all* releases of one year or less, so that a release for 31 days or less can now exceed the maximum pipeline tariff rate, it is unclear why the FERC retains in this context the reference to release to the same replacement shipper "at less than the maximum tariff rate." It appears that FERC's intent is to impose a 28-day period before *any* release of 31 days or less can be re-released to the same replacement shipper without competitive bidding. This is a possible area for clarification.

If the capacity release is for a period less than one year, the asset manager's delivery or purchase obligation must apply for the lesser of five months or the term of the release. If the capacity release is a release of storage capacity, the asset manager's delivery or purchase obligation need only be 100 percent of the daily contract demand under the release for storage withdrawals or injections, as applicable.

The first AMA exemption applies to the bidding requirement. FERC recognizes that all capacity releases made to implement AMAs are prearranged, as the releasing shipper must be able to use the asset manager of its choice to effectuate the components of the agreement. Unlike a normal capacity release — where the releasing shipper is often shedding excess capacity and has no intention of an ongoing relationship with the replacement shipper — in the AMA context the identity of the replacement shipper is often critical because it will manage the releasing shipper's portfolio for some time into the future. Order No. 712 thus exempts capacity releases made as part of AMAs from the requirement of competitive bidding.

For similar reasons, Order No. 712 exempts capacity releases made as part of AMAs from FERC's restriction on "tying arrangements." FERC's normal capacity release rules prohibit releasing shippers from conditioning a capacity release transaction on the replacement shipper's agreement to take unwanted capacity or gas contracts. However, FERC recognizes that AMAs effectively require that the releasing shipper be able to release both its capacity and its natural gas supply arrangements in a single package. FERC notes that, in fact, the very purpose of the transaction would be frustrated if the releasing shipper could not combine the supply and capacity components of the deal.

Order No. 712 thus provides that a releasing shipper in a prearranged release to its asset manager may require that the asset manager (a) agree to supply the releasing shipper's gas requirements and (b) take assignment of the releasing shipper's gas supply contracts, as well as released transportation capacity on one or more pipelines and storage capacity with the gas currently in storage.

To the extent that an AMA-related release transaction will be for a term in excess of one year, the maximum rate cap on capacity release transactions will continue to apply. However, Order No. 712 also amends the regulations to clarify that payments or other considerations exchanged between releasing and replacement shippers in a release to an asset manager are not subject to the relevant pipeline maximum rate. This clarification should facilitate profit-sharing arrangements between releasing shippers and asset managers. In other words, it should provide the parties to an AMA with the flexibility to negotiate mutually acceptable arrangements under which the asset manager shares with the releasing shipper the value the former obtains from the released capacity, without running afoul of the capacity release price ceiling.[2]

Other Aspects of Order No. 712

Order No. 712 also revises the tying prohibition — *even outside the AMA context* — to allow a releasing shipper to include conditions in a release of storage capacity regarding the sale and/or repurchase of gas in storage inventory. This exemption from tying is meant to allow a shipper that

2 Order No. 712 notes that the price ceiling will continue to apply to the rates the asset manager pays to the *pipeline* for the released capacity. The Order explicitly declines to remove the ceiling from short-term pipeline capacity.

releases storage capacity to require the replacement shipper to (i) take title to any gas in the released storage capacity at the time the release takes effect and/or (ii) return the storage capacity to the releasing shipper at the end of the release with a specified amount of gas in storage. The final rule also modifies the capacity release regulations to facilitate state retail open access programs by exempting capacity releases made under state-approved programs from the capacity release bidding requirements.

Finally, in order to monitor the progress of the capacity release market under the new provisions, Order No. 712 directs FERC Staff to monitor the capacity release program and to issue a report on the general performance of that program within six months after two years of experience under the new rule.

What the New Rules Do *Not* Change

Two important underpinnings of FERC's capacity release program are the shipper-must-have-title rule and the prohibition on buy/sells. The shipper-must-have-title rule requires that the shipper must have title to the gas at the time the gas is delivered to the pipeline for transportation and at all times while the gas is being transported on the pipeline. A prohibited buy/sell transaction is a commercial arrangement where a shipper holding interstate pipeline capacity buys gas at the direction of, on behalf of, or directly from another entity, ships that gas through its interstate pipeline capacity, and then resells an equivalent quantity to the same entity at the delivery point. *Both* rules exist to ensure that pipeline capacity only can be "brokered" through the FERC's capacity release regulations. FERC has assessed civil penalties for violations of these rules, and Order No. 712 leaves both rules in place.[3]

Finally, as noted above, the prohibition on roll-overs of exempt prearranged releases of 31 days or less has been retained. This means, in addition, FERC is retaining its prohibition on "flipping" — the practice by which a releasing shipper makes repeated discounted releases of 31 days or less to two or more *affiliated* replacement shippers (without bidding) on an alternating monthly basis. FERC has assessed civil penalties for flipping violations, including during the pendency of the rulemaking that led to Order No. 712.[4]

Thus, while Order No. 712 represents an important liberalization of the capacity release rules, those rules still have important regulatory prohibitions that can be expected to remain an important focus of FERC regulation (and investigation) of natural gas transportation transactions.

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3 Order No. 712 does grant an exemption from the buy/sells prohibition for AMAs that otherwise qualify for the exemptions from bidding and tying, but only for volumes of gas redelivered to the releasing shipper by the asset manager. See Paragraph 165.

4 *See, e.g*. In re *Constellation New Energy-Gas Division*, 122 FERC ¶ 61,220 (2008).