CHAPTER 15

FERC's Order No. 636: Restructuring the Legal Relationships Underlying Natural Gas Sales

in the United States

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[*After this Chapter had been prepared, the Federal Energy Regulatory Commission issued Order No. 636-A, denying rehearing on, but making some changes in, and clarifying other statements in, Order No. 636. Mr. Esposito was kind enough to prepare an addendum to this Chapter--Section 15.11--describ-ing some of the most important aspects of Order No. 636-A. The reader should be careful to consult that Section --Ed.*]

§ 15.01. Introduction.

Since 1938, when the Natural Gas Act[2] (NGA) was enacted, the sale of natural gas in interstate commerce was predominately accomplished in a simple, straightforward manner--a producer sold its gas (directly or indirectly[3]) to a pipeline;[4] the pipeline then sold it to a local distribution company (LDC), which, in turn, sold it to the consumer. Thus, there were only a limited number of transactions to bring gas from the wellhead to the burnertip; those took on a relatively standard appearance.

Ultimately, virtually every step of the overall arrangement required regulatory approval, much of it at the federal level.[5] In the last twenty years or so, the U.S. natural gas industry has weathered shortages and surpluses that have resisted cure by federal government fiat. Now, the federal government largely wants to relinquish the last vestiges of control over the production and sale of natural gas, in favor of allowing competition decide what is best for markets. Its "ticket out" is known as Order No. 636.[6]

In what follows, we first trace the events of the last twenty years leading up to the issuance of Order No. 636. Then, we review the basic tenets of Order No. 636, previewing the general rules that will change how gas is sold in the U.S. Finally, we discuss some more precise parameters of those changes, which are being determined as this chapter is written (in the early Summer of 1992) and will be further determined over the next twelve to eighteen months, as Order No. 636 is implemented on almost ninety interstate pipelines.

Ultimately, something similar to Order No. 636 will be implemented in state utility commission proceedings. For now, we attempt to draw on experience with other regulatory initiatives to predict what the future holds for sellers and buyers of natural gas and the legal instruments used to execute their sales and purchases.

§ 15.02 Background: Setting the Stage.

[1]--Gas shortages of the 1970's and the NGPA.

During the 1970's, the interstate natural gas market suffered periodic shortages. These shortages have generally been attributed to two related factors: (1) federal price regulation, which could not keep up with increases in market prices,(7) and (2) efforts to avoid federal price regulation by keeping gas from moving into interstate markets. The solution to these problems was deemed to be found in integration of the markets and in federal price incentives. Integration was to be accomplished by exempting certain interstate transportation and sales activities from NGA jurisdiction. Federal price incentives were to be provided through book indexing or deregulation of gas prices. Both of these purported solutions would be instrumental catalysts for Order No. 636.

Out of the interstate natural gas supply shortages and Congress' perceived need to deregulate many heavily controlled national economic markets in order to stimulate the nation's growth(8) grew the Natural Gas Policy Act of 1978(9) (NGPA).

The NGPA was "designed in principal part to encourage increased natural gas production"(10) and to "eliminate the dual market that distinguished between interstate and intrastate sales of natural gas."(11) Enactment of the NGPA reflected a congressional belief that a different system of natural gas pricing was needed to balance supply and demand.(12)

The NGPA was, therefore, Congress' attempt to dissolve the regulatory barriers between the interstate and intrastate markets. NGPA Sections 311(13) and 602(b)(2)(14) were added to facilitate the development of a "national natural gas transportation network" without subjecting intrastate pipelines, already regulated by state agencies, to federal regulation.(15)

[2]--FERC Orders Allowing Buyers and Sellers

to Contract Directly.

Following enactment of the NGPA, the natural gas market experienced above-market prices and gas surpluses. These factors placed pipelines under pressure to find new ways to market their natural gas. Unfortunately, by the early 1980s, many pipelines had lost significant portions of their markets to other fuels or other sources of gas supply. Despite this declining market base, pipelines had committed to purchase large quantities of gas at above-market prices. Their average cost of gas exceeded the price that customers with access to alternative fuels or alternative gas sources were willing to pay.(16)

Pipelines responded to this growing problem by enforcing the minimum bill provisions in their tariffs. This had the effect of limiting their customers' ability to reduce purchases or switch to alternative suppliers. Pipelines also initiated "special marketing programs" and selective transportation programs designed to