ALASKA NATURAL GAS
TRANSPORTATION PROJECTS
OFFICE OF THE FEDERAL COORDINATOR

FERC rules ensure gas pipelines treat customers fairly

To make sure they play fair, gas pipeline companies must wall off their staffers who run the line from those who market gas to buyers.

It might be a virtual wall. It might be a physical one. Whatever its form, the wall must be impenetrable, so there's no improper water-cooler talk between employees on one side of the wall and those on the other.

The federal rules that mandate this wall for interstate gas pipelines are laden with lofty language about treating customers alike, about avoiding undue preferences, about not putting competitors at a disadvantage or pricing services unfairly.

Not all pipeline companies market gas these days, but the ones that do must follow the rules.

The agency charged with policing this behavior is the Federal Energy Regulatory Commission, which permits and regulates interstate gas pipelines. State regulators oversee intrastate pipelines.

Think of FERC as the chaperone at the dance who makes sure the boys and girls aren't touching inappropriately ... with the added responsibility of making sure the gawky kids along the wall get an equitable shot at the dance floor.

Isolating different arms of the same business is nothing unique to gas pipelines. Wall Street has insider trading rules intended to separate financiers who know about upcoming business deals from stock-picking co-workers who want to know which stocks to buy or sell. Journalism has ethical barriers that minimize contact between the news and advertising departments.

The concept for gas pipelines dates to 75 years ago, and the conflict-of-interest rules that govern them are much stricter than those for oil pipelines. Back then, the U.S. government was asserting stronger oversight of business in general and it particularly targeted the up-and-coming natural gas industry, a toddler taking its first steps toward becoming the national presence it is today.

The policy of walling off pipeline operations staff has evolved in spasms since. Some of the heaviest revisions have occurred only in the past 25 years or so as the government modernized its regulation of the U.S. gas industry — loosening some strings and tightening others.

A key action occurred in 1992, when FERC issued Order 636. "The Commission must regulate the pipeline transportation system and pipeline sales for resale in a manner that ensures that pipeline control of the transportation system — a natural monopoly — does not give a competitive advantage to pipelines over other sellers in the sale of natural gas," the order says as kind of a manifesto for the "standards of conduct" FERC had imposed on the pipeline industry.

"All natural gas suppliers, including the pipeline as merchant, will compete for gas purchasers on an equal footing," the order says.

SEPARATE BUT EQUAL

In 2009, ExxonMobil and TransCanada set up an office in Anchorage for their proposed gas pipeline project from Alaska's North Slope to Alberta.

ExxonMobil holds the largest proven natural gas reserves in the state and is a significant oil producer in Alaska. Conspicuously, this new gas-pipeline office was in a separate building from Exxon's Alaska production office.

A rival gas pipeline project by North Slope producers BP and ConocoPhillips also set up shop outside the high-rise headquarters of their parent companies.

ExxonMobil executives attached to the pipeline project were excruciatingly careful to keep arms-length from their production colleagues, to the point where one joked of being loath to look in the direction of the production office lest his behavior be misconstrued.

(The projects' offices closed in 2011 and 2012 as all of the companies mothballed plans for an Alberta line in favor of considering a project to pipe gas to a liquefaction plant in coastal Southcentral Alaska for LNG exports to Asia.)

These separate quarters were no accident. These were FERC rules in action. Such rules would be active again if the companies proceed with designing and permitting a pipeline for LNG exports.

GOOD BEHAVIOR

The FERC regulations, known legally as 18 C.F.R. §358, reflect four basic principles:

- Pipeline operations employees must be separated from, and can't communicate with, fellow workers who market gas. FERC calls this the "independent functioning rule." Marketing employees may not conduct or even have access to the pipeline operations center. Operations employees can't market the gas.
- No third party may convey information between the company's pipeline operations and pipeline marketing staff. This is called the "no conduit rule."
- Pipeline information must be disclosed to all customers and potential customers — including the owner company's marketing staff — at the same time. FERC calls this the "transparency rule."
- Pipelines must make their services available to all potential customers — called "open access" — and can't discriminate among customers in their rates or in the scheduling of deliveries. When rules allow rate flexibility — such as giving a break to large anchor shippers, or charging different rates to customers guaranteed space in the pipeline, called "firm transportation service," vs. those who ship only when space is available, called "interruptible service" — similar customers must be treated the same. These are called the "non-discrimination requirements."

Beyond this, pipeline companies must train their workers in these "standards of conduct" annually. New employees must get training within their first 30 days. The same rules apply to FERC regulated electrical transmission companies.

According to FERC staff reports on their investigations since fiscal 2009, when the commission last significantly revised its standards of conduct, the nation's gas pipeline operators and power transmitters have behaved themselves.

In fiscal 2010, a gas company self-reported that several employees got their annual training after the yearly deadline. "To prevent future violations, the company required its Human Resources department to make weekly reviews of training files." Despite the lapse, the under-trained workers didn't breach FERC's standards of conduct. As a result, and because of "the lack of harm and economic benefit," FERC closed the investigation without imposing sanctions.

In fiscal 2011, a company self-reported that 14 of 30 new hires or contractors got their training after their first 30 days on the job, and 14 of 61 contractors whose jobs ended during the year never got training. The company "immediately revised its internal training procedures," and FERC took no further action. It's unclear if this was a pipeline or a power company.

In fiscal 2012, the only infraction involved a gas pipeline company that "improperly made available to marketing function employees" information about capacity during a particular month. Because the company self-reported the rules violation and took steps to keep this from happening again, FERC "staff closed the self-report with no action."

THE 'POSITIVE EVIL'

The government's "trust everybody, but cut the cards" approach to regulating gas pipelines began with the Natural Gas Act of 1938.

This law, for the first time, imposed direct federal regulation of the natural gas industry.

At the time, the petroleum industry was beginning to find ways to make money from the nuisance methane that sometimes rose up their wells with crude oil. The small volume of gas sales was largely limited to towns and industrial plants near the gas fields. But new understanding of how to build reliable long-distance pipelines was making faraway markets possible.

The 1938 law stemmed in part from a 1935 Federal Trade Commission report that called unregulated control of pipelines and wholesale distribution of

Select major federal actions affecting natural gas pipelines

1938 – Natural Gas Act: Launched federal regulation of interstate gas pipelines. Pipelines could continue shipping gas under private contracts rather than be available to all shippers, as long as contracts were made public. Rates must be just and reasonable.

1978 – Natural Gas Policy Act: Began the slow phase out of federal wellhead gas price controls that started in the 1950s. Initially resulted in supply-demand imbalances but eventually sparked more exploration and production.

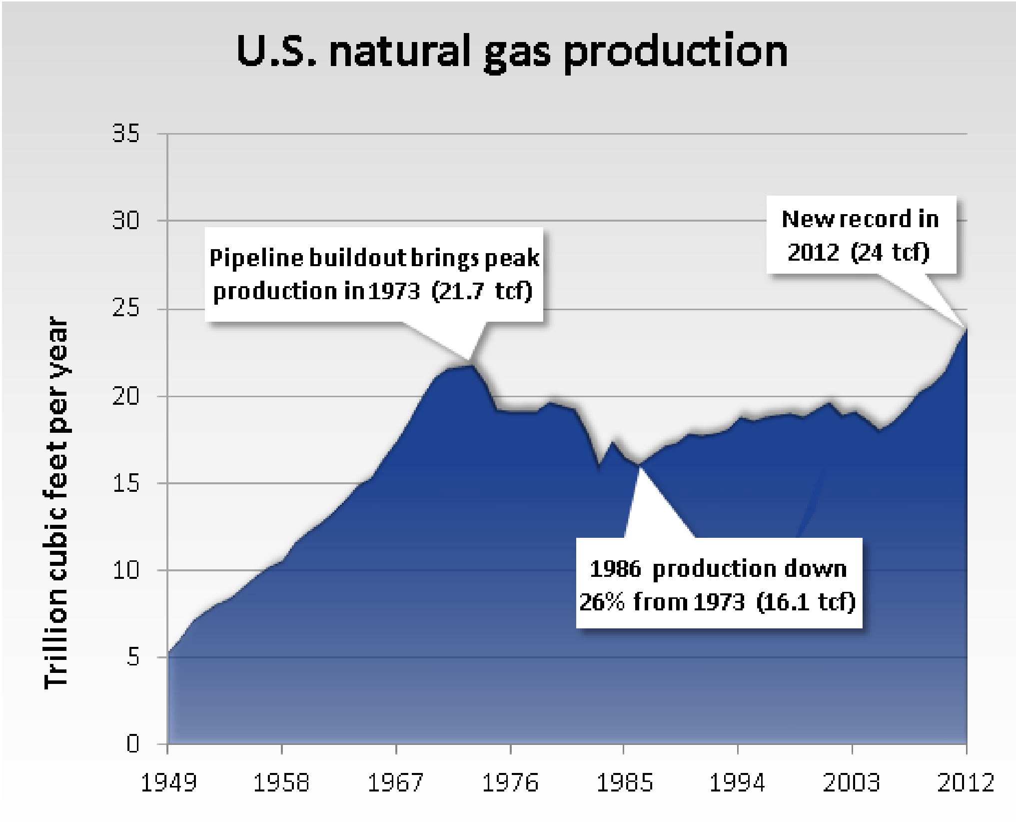
1985 – FERC Order 436: Encouraged interstate gas pipelines to allow open access to their lines, which allowed spot-market volumes for shippers. The order also started changing pipelines into transportation-only businesses; within a decade they had largely ended their other role as gas buyer and seller – acquiring gas at the wellhead and selling it to local gas utilities.

1988 – FERC Order 497: Established standards of conduct that required a pipeline's operations and marketing affiliates to function independently so that competing gas shippers wouldn't be disadvantaged and to protect consumers.

1992 – FERC Order 636: Required interstate gas pipelines to price their gas sales and gas transportation services separately. Pipeline companies needed to compete for customers.

2008 – FERC Order 717: Clarified that the 1988 standards of conduct apply only to pipelines with a marketing affiliate that ships on the pipeline, and that the rules for working independently apply only to staffers involved in day-to-day pipeline operations or marketing.

Sources: Federal Energy Regulatory Commission, U.S. Energy Information Administration, Interstate Natural Gas Association of America, naturalgas.org.



Source: U.S. Energy Information Administration

gas a "positive evil."

"Whoever controls the channels by which a product is marketed controls the market so far as the supply is concerned. Concentrated control of those channels confers a strategic advantage that may be used by those possessing it to extend their domination into both the producing and distributing branches of the industry," the trade commission said.

Congress considered the natural gas industry an environment where "monopolistic forces were distorting the market price of natural gas," as a court ruling later put it.

The gas pipeline industry back then, and until the 1980s, worked like this:

Gas pipeline owners would acquire gas from producers near the wellhead, transport the gas to market, then sell their gas to a local gas utility or industrial plant. The Federal Power Commission and its successor as of 1977, the Federal Energy Regulatory Commission, regulated the prices along this path to make sure they all were "just and reasonable."

A BUMPY ROAD

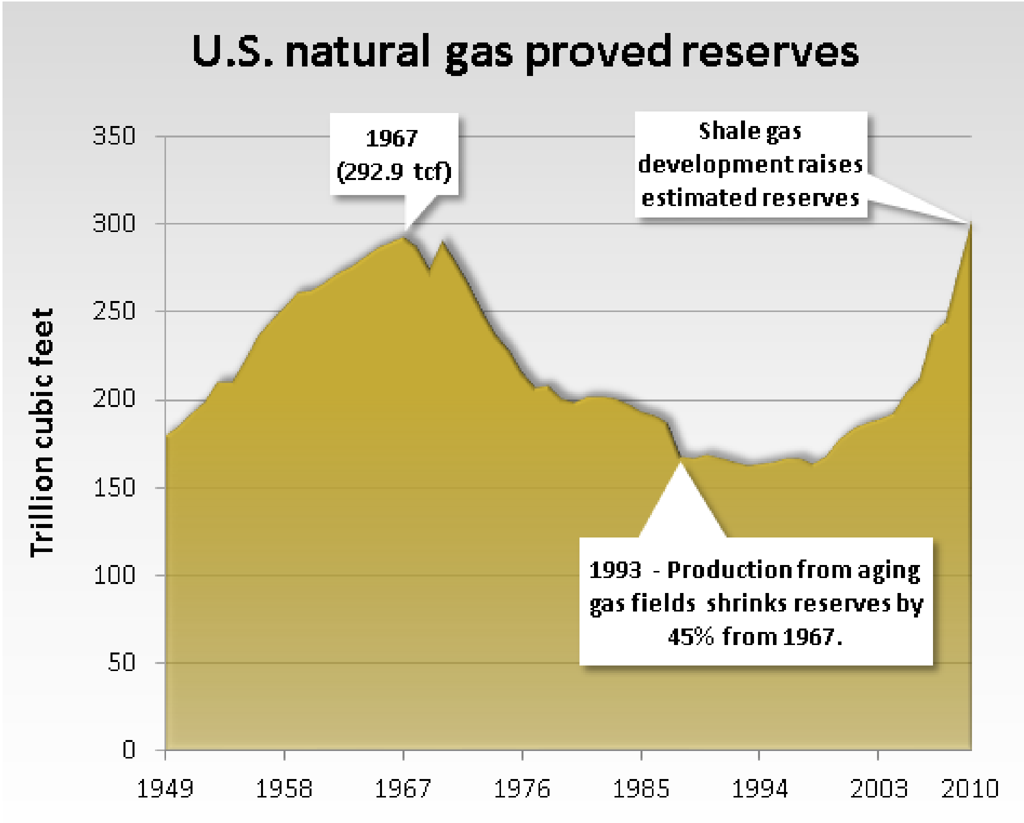
By the 1970s, Congress had an epiphany. A new paradigm took root: Lighten the government's regulation of the gas industry.

The premise was that heavy-handed regulation — particularly of wellhead prices — had caused natural gas shortages. Low, regulated prices stifled investment in new production — wellhead prices averaged less than 50 cents per thousand cubic feet 1960 through 1976. Amid these shortages, the first plans arose to build an Alaska gas pipeline that would ship North Slope methane to the rescue.

In 1978, Congress passed the Natural Gas Policy Act to kick off deregulation. The process took about 15 years, and it did result in discovery of more gas reserves to fill the market. The new gas age that dawned helped kill the 1970s-era hopes for an Alaska gas line.

The first steps in this deregulation involved loosening, eventually removing, price controls.

By the mid-1980s, FERC was ready to reconstruct the gas-pipeline industry itself. When FERC was essentially done, after a series of steps culminating with Order 636 in 1992, the pipelines no longer bought gas from producers, shipped it, then sold the gas to utilities and industrial plants. The pipeline companies often didn't own the gas they



Source: U.S. Energy Information Administration

shipped; they merely transported other people's gas. They were becoming a service business.

The whole trip traveled a bumpy road. A court that sanctioned a 1985 FERC deregulation step noted the order gave pipeline companies a dismal choice about their future — "between the noose and the firing squad," as the court put it.

Each step FERC took warped the marketplace in a new way, which got addressed in later steps. Order 497 in 1988, Order 636 in 1992, Order 2004 in 2003, and Order 717 in 2008 all refined the commission's policies on what constitutes acceptable conduct between a gas pipeline and its customers, and between gas pipelines and their affiliates. (The 2008 order came about after a judge voided the 2003 order, saying FERC overstepped when it walled off a pipeline company's non-marketing affiliates — gas producers, processors, gatherers and local gas utilities — from the pipeline operations staff.)

Not surprisingly, the pipeline players resisted many of the changes. They argued there were no problems that needed fixing, that they should operate on the honor system and police themselves, that the rules unnecessarily burden them with insane levels of paperwork, or that FERC could deal with rare transgressions case by case. They argued over specific wording of rules. They filed suit.

FERC plowed forward, sometimes modifying the proposed rules when it thought the industry made winning points.

Throughout, dating back to the Natural Gas Act of 1938, the regulator drummed on a constant theme: Fairness.

"Pipelines continue to have economic incentives to show undue preferences toward their marketing affiliates," the commission said in 1988.

"The natural gas industry has not completed its evolution to the point where all gas is shipped on even terms without regard to the identity of the supplier," the commission said in 1992.

"As natural monopolies, pipelines if unregulated would possess the ability to engage in monopolistic pricing for transportation services and discriminate against unaffiliated entities that seek to transport gas," a federal appeals court said in 2006.

In that lawsuit, which the industry brought, the court knocked down FERC's attempts to update the standards to encompass a modern-day natural gas company that might produce gas as well as pipe it and trade it on the markets. The court said that without evidence of actual abuse — as opposed to the potential for abuse — by those affiliates, FERC could not impose the standards on non-marketing affiliates of gas pipeline companies.

FERC's focus, the court said, should remain on the narrow, documented problem: Pipelines favoring transport of its own gas to the disadvantage of competitors. Regulation is needed to ensure pipelines provide "equal treatment to sellers in areas such as scheduling, transportation, and speed of service."

Office of Federal Coordinator legal counsel Joseph M. Oglander contributed to this article.

For more information, please visit our website: www.arcticgas.gov

Contact information:
Bill White, Researcher/Writer for the OFC
(907) 271-5240
bwhite@arcticgas.gov

General Questions:
info@arcticgas.gov

Locations:
OFC Washington, DC
1101 Pennsylvania Ave. NW, 7th Floor, Washington, DC 20004
(202) 756-0179

OFC Alaska
188 W. Northern Lights Blvd., Suite 600, Anchorage, AK 99503
(907) 271-5209