

Mitigating Volatility Or Inviting Market Power?

FERC lowers the bar for obtaining market-based rates for natural-gas storage.

BY KENNETH S. CULOTTA AND JAMES E. GODDARD

The first regulatory changes following the passage of the Energy Policy Act of 2005 (EPACT) are starting to pick up steam—and encountering multi-faceted criticism—as the gas industry reacts.

On Dec. 22, 2005, the Federal Energy Regulatory Commission (FERC) issued a notice of proposed rulemaking (NOPR) related to the granting of market-based rates for natural-gas storage service. Its purpose: to amend FERC regulations to make it easier for storage providers to obtain market-based rate treatment, thereby encouraging the development of new storage facilities. Most market observers, including FERC, believe that additional underground gas storage infrastructure is necessary in the United States to mitigate the volatility of natural-gas prices and to help the United States compete in the worldwide market for imported liquefied natural gas (LNG). Yet at an open meeting held on June 15, 2006, FERC staff noted that there is currently only one natural-gas storage facility application pending at FERC.

The difficulty storage providers encounter in gaining FERC approval to charge market-based rates is one of the greatest impediments to storage development. In the past, FERC would not grant market-based rates to a storage provider that had market power, unless

the storage provider adopted conditions that sufficiently mitigate its market power as measured by traditional criteria. The criteria for showing lack of market power are sometimes difficult to meet, especially in areas where there are only a limited number of storage-service providers. For example, in 2002, Red Lake Gas Storage LP proposed to construct a new underground storage facility in Arizona—an area not currently served by underground gas storage—and sought approval from FERC to charge market-based rates. Using its market power criteria then in effect, FERC denied Red Lake's market-based rate request based on its determination that, if built, the market Red Lake would operate in would be extremely concentrated, and Red Lake would have substantial market power.

The NOPR

Many industry participants also have complained that FERC's market-based rate policies have resulted in a general reluctance within the industry to develop needed storage and have exacerbated gas price volatility, especially in underserved markets like the Southwest. As the first wave of imported LNG washes ashore, concerns about the need for storage have increased. FERC's NOPR attempts to address these concerns in two ways.

First, FERC proposes to modify its market-power analysis requirements to allow storage providers to include non-traditional storage alternatives, such as local production, LNG, and pipeline capacity in their market-power analyses. This change was not mandated legislatively, but responds to perceived limitations on the market-power test as traditionally applied. Second, FERC proposes to implement Section 312 of EPACT, which adds Section 4(f) to the Natural Gas Act (NGA). New Section 4(f) permits FERC to allow market-based rates for new storage facilities, even if the storage provider is unable to show that it lacks market power, but only if FERC finds that the market-based rates are in the public interest and necessary to encourage the construction of needed storage capacity and that customers are adequately protected. In the NOPR, FERC interpreted Section 4(f) as applying only to new storage facilities not in existence on Aug. 8, 2005, the date EPACT is enacted, though as will be seen below, that conclusion is not shared by all parties.

FERC also proposes to subject those obtaining market-based rates, after a market-power determination has been conducted, to periodic market-power reviews to ensure that abuses do not develop. FERC's proposed regulations, however, do not similarly require a periodic review at specified intervals in cases where market-based rates are allowed under Section 4(f) of the NGA. Although Section 4(f) specifically requires FERC to "review periodically whether the market-based rate is just, reasonable, and not unduly discriminatory or preferential," FERC argues that a periodic market-power review is not necessary for market-based rates granted under Section 4(f), because FERC can meet the periodic review requirement through regular »

The difficulty in gaining FERC approval to charge market-based rates is one of the greatest impediments to gas storage development.

monitoring and taking appropriate action under Section 5 of the NGA either *sua sponte* or in response to a complaint.

Not surprisingly, the NOPR met with an energetic response. Thirty-two parties, representing hundreds of constituents and almost every facet of the natural-gas industry from producer to consumer, filed comments with FERC related to the NOPR by the filing deadline of Feb. 27, 2006. An additional party filed comments one day later and requested that FERC consider the comments during FERC's review. In addition, although reply comments are not authorized specifically in the NOPR, five parties filed reply comments and three other parties filed supplemental comments between March 3, 2006, and May 31, 2006. The parties filing comments can be grouped loosely into the following categories: (a) independent storage developers; (b) interstate pipelines or affiliated storage companies; (c) local distribution companies; (d) producers and marketers; (e) investor-owned electric companies; (f) a state utility commission; (g) industrial users of natural gas; and (h) a consumer group. The positions taken by the commenters, predictably, ran the gamut from enthusiastic support to outright horror. The comments of each group are summarized below.

Independent Storage Developers

Eleven independent storage developers or equity providers to independent

storage projects filed comments to the NOPR. The issues raised by these entities can be categorized as follows:

1. Support for the expansion of the definition of the relevant product market to include non-storage competitive alternatives for purposes of conducting a market-power analysis;

2. General agreement that Section 4(f) should apply only to new facilities, not expansions of existing capacity;

3. A need for FERC to recognize and address the differences between independent storage developers and storage providers affiliated with interstate pipelines to be sure that subsidization through rolled-in rates or other preferences does not occur. This comment was predicated on the conviction that independent storage inherently tends to drive market efficiencies by linking unrelated providers via hubs and enhancing the pipeline grid;

4. FERC should modify its rules to provide that if market-based rates are authorized for a facility, but upon its periodic review FERC determines that market-based rates are no longer justified, FERC then should not interfere with the contracts entered into between the storage provider and its customers prior to such determination. This concern stemmed from the fact that long-term contracts typically are required to underpin the financing of independent storage and that failure to respect the sanctity of these contracts would impede such financing; and

5. The periodic review requirement should be imposed on a prospective

basis only. Facilities currently charging market-based rates should not be subject to it.

Interstate Pipelines and Affiliated Storage Companies

Ten interstate pipelines, storage companies (including two separate LDC groups) affiliated with interstate pipelines, and one interstate pipeline group filed comments to the NOPR. The issues raised by these entities generally can be categorized as follows:

1. Support for the expansion of the definition of the relevant product market to include non-storage competitive alternatives for purposes of conducting a market power analysis;

2. Elimination of the proposal to require an automatic five-year market power review;

3. Section 4(f) eligibility for market-based rates for new capacity from existing facilities;

4. In determination of an applicant's market power, the capacity of the applicant's affiliates should not be included in the calculation, or, if affiliated capacity is considered, it should be included on the competitive alternative side of the equation. The commenters argued that the requirement that affiliated capacity be considered in the applicant's market-power analysis is a vestige of outdated FERC policy, and intervening events have eviscerated the need for such a requirement; and

5. FERC should allow pipelines to seek market-based rates for all classes of storage and related services, such as park and loan services and other services that provide storage-type imbalance management functions.

Local Distribution Companies

Four LDC groups filed comments to the NOPR. Not surprisingly, these

our products aren't just products

They're megawatts when you need them most.

Our products and services are the result of innovation, customer partnerships and feedback, continuous improvement, and a commitment to quality - in every aspect of our business. That's what it takes to build a platform trusted by hundreds of US utilities, and that's what we do best.



Demand Response | Advanced Metering

comverge

888.565.5525 | www.comverge.com

amra booth 615

were the least enthusiastic about the proposed rule changes. While one stated that it supported the overall regulatory framework suggested in the NOPR for implementing Section 4(f), another, taking perhaps the most extreme position of all, suggested that FERC should withdraw the NOPR and significantly revise its approach to implementing Section 4(f) consistent with that section's explicit terms, which (it notes) explicitly requires consumer and customer protections. One commenter, echoing the concerns of the independent storage providers, suggested that the proposed regulations do not adequately protect customers of cost-based storage services from a misallocation of costs when a single storage service provider operates both cost-

based rate and market-based rate storage services. One states that customers can and should be protected by a modification in the proposed regulations that requires storage service providers to account for costs incurred in providing market-based rate storage services separately from cost-based rate storage services. Another opposed the broadening of standards to permit market-based rates for existing storage services as being unnecessary and potentially harmful to customers.

Producers and Marketers

One marketing company and two industry groups representing natural-gas producers filed comments to the NOPR. The marketing company and one of the industry groups urged

FERC not to expand the definition of the relevant product market for storage to include close substitutes for gas-storage services, as FERC has proposed in the NOPR. As an alternative, the industry group suggests that if FERC modifies its current policy regarding market-based rates, such modifications should be applicable only to new storage facilities, not expansions of existing facilities. It further suggests that a series of technical conferences or workshops should be conducted to allow industry participation so FERC could successfully devise a proper market-based rate program. Although it did not directly challenge FERC's proposal to expand the definition of the relevant product market for storage, the other industry group encourages FERC to consider

the effect the expanded definition could have on all services under FERC's jurisdiction, not just within the confines of an individual application by a storage operator.

Shareholder-Owned Electric Companies

An association of U.S. shareholder-owned electric utilities and an individual shareholder-owned electric utility filed comments to the NOPR. The association of electric utilities generally agree with the analysis provided by FERC in the NOPR. While the individual electric utility also generally agree with FERC's proposed rules, it suggests that: (i) while FERC implies in the NOPR that an unsuccessful open season could serve as a generic indicator of the need for storage in a specific area, parties protesting the application should be allowed to present evidence showing that the public interest would be better served by cost-based rate treatment; and (ii) FERC should adopt a market power analysis for gas storage markets that takes into account the potential impact on the national market and factors into its "competitiveness" analysis the interdependence of the gas and electric markets.

State Utility Commission

The New York Public Service Commission (NYPSC) supports FERC's efforts to encourage storage development, but cautions the commission to evaluate market-power studies on a case-by-case basis, because local production in New York is not, in many instances, a viable alternative to storage service. The

NYPSC also suggests that FERC hold to a "public interest" standard in determining whether a new storage facility should be granted market-based rates, notwithstanding the failure of the applicant to demonstrate a lack of market power.

As the NYPSC noted, it is in the "public interest" to encourage the entrance of independent, third-party storage providers. Conversely, it may not be in the public interest to encourage the construction of new storage facilities by a pipeline with a dominant market share in the relevant product and geographic markets. Finally, the NYPSC suggests that generic safeguards should be imposed to protect customers from market-power abuse, and specifically suggests that a condition prohibiting the withholding of capacity should be included in such safeguards.

Gas Consumer Groups

A group representing industrial consumers of natural gas and a separate group representing end-use customers filed comments to the NOPR. The industrial consumer group argues that the inclusion of non-traditional market substitutes in the market-power analysis is unnecessary, because developers of new storage facilities could avail themselves of Section 4(f) and thereby obtain market-based rates even if they could not establish the absence of market power. The group requests that FERC convene a technical conference to determine appropriate generic safeguards to protect customers. Similarly, the customer advocate group suggests

that if FERC develops a set of generic safeguards to protect customers, then FERC should present the safeguards to interested parties for comment. In addition, the group urges FERC to require applicants for market-based storage rates to post continuous, real-time data on the amount of contracted storage service and storage capability for each storage service offered, thereby enabling interested parties to determine whether a storage operator is attempting to exercise market power by withholding capacity.

Order No. 678

FERC considered each of the positions of the parties and issued its 121-page Order No. 678 on June 19, 2006. FERC officially adopted modifications to its regulations related to market-based natural-gas storage rates. FERC's new regulations significantly ease the burden for storage providers to obtain market-based rate treatment in order to encourage the development of new storage facilities. Order No. 678 addresses industry concerns regarding the difficulty of storage providers in obtaining market-based storage rates under FERC's previous policies in two ways.

1. Inclusion of Non-traditional Alternatives. First, FERC modifies its market-power analysis requirements to allow storage providers to include non-traditional storage alternatives, such as local production, availability of LNG, and pipeline capacity in its market-power analyses. As noted by FERC, broadening the range of storage alterna-

Deliver your marketing message to key utility decision makers with Fortnightly!
For information on print and electronic opportunities, call 703-847-7759 or visit: www.puif.com


tives that may be considered as competitors “is supported by changes in the natural-gas markets that have occurred since the mid 1990s. In today’s markets, these non-storage products may well serve as adequate substitutes for gas storage in appropriate circumstances.” (Order No. 678, at ¶ 25.) The legitimacy of the storage alternatives will be considered prospectively by FERC on a case-by-case basis, and the commission will not require applicants previously granted market-based rates to resubmit an application under the broader definition of product market adopted by FERC in Order No. 678.

2. Market Power and “New Facilities.” Second, FERC implements NGA Section 4(f), which, as noted above, permits FERC to allow market-based rates for new storage facilities—even if the storage provider is unable to show that it lacks market power—if FERC finds that the market-based rates are in the public interest and necessary to encourage the construction of needed storage capacity, and that customers are adequately protected. Although FERC in its NOPR of Dec. 22, 2005, originally interpreted Section 4(f) as applying only to new storage facilities not in existence on Aug. 8, 2005, the date EPACT was enacted, in Order No. 678 FERC reversed its course and interpreted Section 4(f) to apply both to greenfield storage facilities and expansions of existing facilities. FERC noted that “significant and substantial enhancements to storage capacity can be achieved at existing fields and it is unnecessary to exclude service from such expansions from consideration for market-based rates by narrowly interpreting the term ‘facility’ in the context of Section 4(f).” (Order No. 678, at ¶ 115.)

Other Notable Provisions of Order 678: Periodic Review. In another rever-

MDU Resources Group, Inc.

Building a Strong America / A Legacy of Leadership



At MDU Resources, strong leadership is a deep-seated legacy. It is the theme that runs through our history, connecting past with present. With integrity as their guide, our people have used their expertise to build this company from a small utility on the prairies in 1924 to today's \$3.5 billion diversified international enterprise.

Our 2005 Successes

- Achieved record earnings of \$274.4 million
- Grew revenues by 27 percent
- Realized a 26 percent annual total shareholder return
- Increased dividends for 15th consecutive year

MDU Resources Group, Inc. • Centennial Energy Resources
Fidelity Exploration & Production Co. • Great Plains Natural Gas Co. • Knife River Corporation
MDU Construction Services Group, Inc. • Montana-Dakota Utilities Co. • WBI Holdings, Inc.

701-530-1000 • www.mdu.com

sal of course, in Order No. 678 FERC removes the requirement proposed in the NOPR subjecting those obtaining market-based rates, after a market-power determination has been conducted, to periodic market-power reviews ensuring that abuses do not develop. After considering the many comments filed by industry participants on this topic, FERC finds that a generic periodic market-power review is not necessary for market-based rates to be granted by FERC, because FERC can meet the periodic review requirement through regular monitoring and taking appropriate action under Section 5 of the NGA either *sua sponte* or in response to a complaint. However, FERC does retain the right to require storage providers with a market share greater than 10 percent to submit to

additional reporting requirements if the facts presented in the relevant case so warrant.

The revisions to FERC’s regulations regarding market-based storage rates clearly will make it easier for existing storage providers and greenfield storage developers to obtain market-based rates for new or expanded natural-gas storage service. It is yet to be seen how many storage providers will take advantage of the new rules, but there should be an increase in the number of storage projects launched over the next few years as a result of these changes as well as increased demand for natural-gas storage in the United States. ■

Kenneth Culotta is a partner at King & Spalding. Contact him at kculotta@kslaw.com.