

traditional cost-of-service ratemaking standards. The policy statement also established five regulatory standards for the evaluation of specific proposals—that incentive proposals must: (1) Be prospective, (2) be voluntary, (3) be understandable, (4) result in quantified benefits to consumers, and (5) demonstrate how they maintain or enhance incentives to improve the quality of service. The standard pertaining to the quantification of benefits requires the inclusion of an absolute upper limit on the risk to consumers, with the overall cap on incentive rate increases based on projected traditional cost-of-service rates. In view of the lack of response to the October 30, 1992 policy statement and the changes in the natural gas market that have occurred since the issuance of the policy statement (principally the implementation of Order No. 636), the Commission believes it is appropriate at this time to revisit the issue of incentive rates for pipeline services and requests comments in response to the following questions:

9. Why have there not been any incentive proposals under the policy established in Docket No. PL92-1-000?

10. a. Should the Commission change its existing standards for incentive rate proposals?

b. If so, what specific criteria should the Commission employ when evaluating incentive rates?

11. Are there models for incentive regulation that the Commission should consider, such as the California performance-based program?

12. a. What are the benefits and drawbacks of incentive rates, and the policy objectives the Commission should pursue with an incentive rate method?

b. Is incentive ratemaking appropriate for the natural gas companies regulated by the Commission?

c. Please identify and discuss any legal issues that the Commission has not yet considered with this type of rate method.

There are other pricing methods which are neither market-based nor incentive-based, such as reference pricing (in which the rate is determined by reference, e.g., to the rates of another company or the price of another product). The Commission also requests comments on criteria for evaluating such proposals:

13. What other rate methods should the Commission consider beyond the market-based and incentive-based methods covered above?

14. a. What would be the benefits and drawbacks of any such methods?

b. Please identify and discuss any particular legal or procedural issues raised by a specific method.

15. What criteria would the Commission use to evaluate such proposals?

The Commission is requesting written comments on these questions and the attached staff paper on market-based rates. The Commission requests parties to identify the numbered questions in their comments to the maximum extent possible. An original and 15 copies of written comments should be filed with the Secretary of the Commission within 60 days of the issuance of this notice, and should refer to Docket No. RM95-6-000.

By direction of the Commission.

**Lois D. Cashell,**

*Secretary.*

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#### Market-Based Rates for Natural Gas Companies

##### *A Staff Paper*

The Commission has been requested by various companies to approve market-based pricing for both firm and interruptible transportation, for capacity released in the secondary market, for storage and for market hub services such as the "switching" and "parking" of natural gas. Approval of any of these proposals is contingent on the Commission finding that the company in question lacks significant market power. The purpose of this paper is to propose criteria that could be used to evaluate these proposals.

In developing these criteria staff has reviewed the Commission's prior experience with market-based ratemaking for natural gas companies, oil pipelines, and public utilities. In those cases the Commission consistently used the same general framework to evaluate requests for market-based rates. In addition, the experiences in three other industries (railroads, telecommunications, and airlines) also have been reviewed to determine whether there are lessons that can be drawn. For illustrative purposes the paper applies the proposed criteria to a hypothetical case. Finally, the paper discusses the other services that may

qualify for market-based rates as well as factors the Commission may want to consider in monitoring market-based rates.

#### I. The Applicable Legal Standards

Operating under the "just and reasonable" standard of the Natural Gas Act (NGA), the Federal Power Act (FPA), and the Interstate Commerce Act (ICA), the Commission generally authorizes rates based on the cost of service. However, as the Supreme Court has ruled on numerous occasions,<sup>1</sup> the just and reasonable standard does not limit the Commission to any particular ratemaking methodology; rather, the Commission has flexibility in selecting ratemaking methods.

Courts have held that non-cost factors can legitimate a departure from cost-based rates. Departures from cost-based rates have been found to be justified when: (1) The changing characteristics of the industry make advisable or necessary a new approach;<sup>2</sup> (2) the deviations from costs are not unreasonable or inconsistent with statutory responsibilities;<sup>3</sup> and (3) the regulatory scheme acts as a monitor to determine whether competition will keep prices within a zone of reasonableness or to check rates if it does not.<sup>4</sup> However, in ruling that rates need not be linked to costs in order to be just and reasonable, the court in *Farmers Union II* held that the Commission cannot merely assume that competition will ensure just and reasonable prices: "[m]oving from heavy to lighthanded regulation within the boundaries set by an unchanged statute," can only "be justified by a showing that under the current circumstances the goals and purposes of the statute will be accomplished through substantially less regulatory oversight."<sup>5</sup>

The Commission's authority to approve market-based rates under the

<sup>1</sup> See *Mobil Exploration & Producing Southeast Inc. v. United Distribution Companies*, 498 U.S. 211 (1991) (affirming the Commission's Authority to consolidate existing "vintage" price categories and set a single ceiling price for "old" gas); *Duquesne Light Co. v. Barash*, 488 U.S. 299, 310 (1989); *Permian Basin Area Rate Cases*, 390 U.S. 508, 517 (1979); *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944).

<sup>2</sup> *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1503 (D.C. Cir. 1984) (*Farmers Union II*), cert. denied sub nom., *Williams Pipe Line Co. v. Farmers Union Central Exchange, Inc.*, 469 U.S. 1034 (1984) (citing *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968)).

<sup>3</sup> *Farmers Union II* at 1502 (citing *Mobil Oil Corp. v. FPC*, 417 U.S. 283 (1974)).

<sup>4</sup> *Id.* at 1509 (citing *Texaco, Inc. v. FPC*, 474 F.2d 416, 422 (D.C. Cir. 1972), vacated, 417 U.S. 380 (1974) (the court of appeal's decision was vacated on other grounds)).

<sup>5</sup> *Id.*