Department of Justice

COMPETITION POLICY AND THE NATIONAL ENERGY STRATEGY: UNLEASHING MARKET FORCES IN THE NATURAL GAS INDUSTRY

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I am honored to address this conference on antitrust in natural gas and electricity, and I am gratified to see the growing awareness of the role of antitrust enforcement in the energy industry.

As the industry adjusts to deregulation, the protections afforded by tough but rational antitrust enforcement will become increasingly important. Once the regulatory controls are removed, competition should thrive, provided that behavior is shaped by adherence to antitrust law. To help assure this result, you can expect that federal antitrust enforcement will keep a higher profile as free market forces are unleashed in the energy industry. That has been the theme of this conference, and I wish to endorse it as a timely and important message. This morning, however, I will focus my remarks not on antitrust enforcement but instead on the competition policy considerations that underlie the deregulatory efforts of the National Energy Strategy in the natural gas industry.

When I began as Assistant Attorney General in charge of the Antitrust Division nearly two years ago, I understood that the activities of the Division went well beyond the price fixing

cases and merger enforcement for which the Division is perhaps best known. Less than a month after I reported to the Department, I began to appreciate, as well as understand, the significance of the Division's broader role in competition advocacy, for it was then that the President set in motion a comprehensive review of the nation's energy policy.

On July 26, 1989, President Bush directed Secretary of Energy Watkins to initiate the development of what we now know as the National Energy Strategy. In his initial charge to the Secretary, President Bush directed that "[a] keystone to this strategy is going to be the continuation of the successful policy of market reliance." At the same time, the President predicted that development of the strategy would not be easy.

Certainly the last two years have validated the President's prediction. More significantly, the fruits of those efforts conform to the President's directive. Market reliance is a keystone of the National Energy Strategy Report released last month and the National Energy Strategy Act reported to Congress this week.

Because the policy of market reliance is also the keystone of the antitrust laws, the Department of Justice played a substantial role in the development of the Report and the

legislation. It is from that perspective that I would like to review this morning some of the competition policy aspects of the National Energy Strategy.

A major objective of the NES is to lessen the nation's vulnerability to oil price shocks resulting from unanticipated constrictions in supply. While it took an event of the magnitude of the Persian Gulf crisis to make ordinary Americans aware of the nation's vulnerability to oil price shocks, the Administration had already targeted the problem as a top priority for NES review.

After careful study, the NES working group reached several conclusions, all pointing to the need for deregulation of the natural gas industry. Vulnerability to oil price shocks could be substantially reduced if the economy were sufficiently flexible to allow efficient substitution away from petroleum products to natural gas in the event of an oil price shock. But a maze of unnecessary regulation in the natural gas industry currently hampers the flexibility of the U.S. economy. The NES Act would remove unnecessary regulation to enable all segments of the natural gas industry to expand and take advantage of market opportunities. This is consistent with the overall NES approach that -- and I quote -- "[w]herever possible, markets should be allowed to determine

prices, quantities, and technology choices. In specific instances where markets cannot or do not work efficiently, government action should be aimed at removing or overcoming barriers to efficient market operation."

The problem of inflexibility in the natural gas industry does not lie in the production sector. The Natural Gas Wellhead Decontrol Act of 1989 effectively eliminated wellhead price regulation for 90 percent of the natural gas produced in this country, with the remaining ten percent to be deregulated on January 1, 1993. Natural gas producers therefore are largely able to respond efficiently with increased gas production to rising oil prices and the consequent increase in demand for natural gas.

The source of inflexibility in the natural gas industry today lies in the transportation sector. In order for increased production to have the most beneficial impact possible, there must be an equally efficient gas transportation system. Unfortunately, current regulation of natural gas pipelines may unnecessarily impede the expansion of pipeline capacity and the efficient utilization of existing capacity. To remedy this situation, the NES Act seeks to modify the Natural Gas Act's certification requirements and procedures, as well as its regulation of pipelines' gas sale and

transportation rates. These reforms are intended to remove unnecessary disincentives to pipeline expansion and to promote more efficient allocation of existing capacity.

Before discussing the details of the National Energy Strategy reforms, I would like to stress that the issues of certification and rate regulation reform are interrelated. Even the best certification scheme could be rendered meaningless by inefficient rate regulation. The ability efficiently to use the pipeline plays an important role in the incentive to build the pipeline in the first place. An efficient rate regulation mechanism can enhance efficient utilization of new pipeline facilities subject to the mechanism, thus removing one disincentive to pipeline construction. But the beneficial impact on pipeline construction of rate regulation reform will be negated if pipeline certification remains prohibitively slow and costly. Effective reduction of vulnerability to oil price shocks requires a coordinated plan of both certification and rate regulation reform, and I am proud to tell you that the NES is such a plan.

Pipeline Certification Reform

Today, under section 7(c) of the Natural Gas Act, firms must obtain a certificate of "public convenience and necessity" from the Commission before constructing, expanding, acquiring or operating interstate natural gas facilities. The applicant must show that its proposal has taken into consideration such issues as adequacy of gas supply, adequacy of demand, adequacy of the proposed facilities, reasonableness of costs, and reasonableness of proposed initial rates. As a result, the administrative proceedings that accompany the traditional certification procedure often involve lengthy evidentiary hearings. Some proceedings can take years to complete before the Commission determines whether the proposed action meets the public convenience and necessity requirement. Rates charged by pipelines built with this traditional certification are subject to continued Commission regulation.

The recently completed decade-long process for permission to construct a pipeline to service the Northeast -- the so-called Iroquois Pipeline -- is a frequently cited example of the inefficiency of traditional certification proceedings. The Northeast is a region of the country where expanded service is urgently needed. New pipeline construction is needed to address the serious problem of undercapacity in that region, yet it took a decade to obtain the necessary authorization to commence construction on the Iroquois pipeline. The prospect

of that kind of enormous delay and costly proceedings is bound to have a deterrent effect on the construction of new gas pipeline capacity, and obviously the delays themselves could paralyze responses to crises in oil supply.

To address this situation, the NES Act recommends three nonexclusive alternatives to traditional certification procedures. These alternatives would help remove impediments to new construction and expansion without sacrificing environmental and competition safeguards.

The first alternative is an optional expedited certification procedure allowing applicants to receive a certificate without undergoing a lengthy hearing. Pipelines that elect the optional expedited certification procedure would forfeit some of the advantages of the traditional certification route, but these losses would be offset by considerable advantages. The public convenience and necessity requirement is deemed to be met if the applicant agrees not to include any costs associated with the subject facility in any rates or charges filed with the Commission for its other facilities. It must also agree not to participate in the Commission's proceedings to consider certifications of competing pipelines. Thus, an application for optional expedited certification could not be challenged by a potential competitor on the basis that

the certificate would be prejudicial to that competitor. In exchange for this certainty, the applicant would be foreclosed from contesting the application of a competitor seeking to serve the same market. Moreover, as I will explain in a moment, traditional rate regulation would no longer apply, and the applicant, rather than its customers, would bear the entire risk associated with construction and operation of the facility.

The Commission would still need to conduct hearings prior to the issuance of an optional expedited certificate, but competition issues would be off the table. Hearings would be limited to environmental issues, zoning determinations, last use questions and other related concerns. National Environmental Policy Act ("NEPA") compliance could still be required because issuance of the certificate would be a "major federal action". In addition, a pipeline that obtains a certificate under this optional expedited procedure would be entitled to the same rights of federal eminent domain and preemption of state regulation that are provided under traditional certification.

The second alternative contemplated by the NBB Act is that construction, extension, acquisition or operation of pipeline facilities may be accomplished without any certification from the Commission. Like pipelines electing the optional expedited

certification procedures, pipelines electing this so-called "non-jurisdictional" option would be precluded from contesting before the Commission any application for a competing pipeline.

Since no certificate issues under the non-jurisdictional option, there is no "major federal action" triggering NEPA review. On the other hand, without certification the right of federal eminent domain would be unavailable. State economic regulation would be pre-empted, but other types of state action would apply. As I will explain in a moment, non-jurisdictional pipelines also would be freed from traditional rate regulation.

As a third alternative, the NES Act would codify existing Commission practice by specifically providing for construction without a certificate of pipelines for transportation authorized under Section 311 of the Natural Gas Act -- so-called Section 311 facilities. The Commission's interpretation of Section 311 already allows for this, provided the Commission is notified prior to the commencement of construction. Under the NES Act, notice to the Commission would no longer be necessary. Instead, the NES Act would require notification of affected state agencies 30 days prior to the commencement of construction.

Here too, since the Commission does not issue a certificate under this alternative, there is no "major federal action" on the part of the Commission to trigger NEPA review. Eminent domain rights would not attach, but state regulation of transportation rates would be preempted.

Where NEPA review is required, as would be the case with either traditional or optional expedited certification procedures, the NES Act would streamline existing environmental review procedures. Under existing law, any federal agency whose authorization is required by the proposed pipeline construction must comply with NEPA. When preparing an Environmental Impact Statement ("EIS"), the Commission may be the lead agency, coordinating the EIS with other Federal agencies. It must consider the comments of all participating federal agencies before making a determination of the public convenience and necessity of the pipeline project. The Commission, however, possesses no authority to impose a deadline on administrative proceedings undertaken by other federal agencies. As a result, NEPA review can and does delay certification substantially, and the likelihood of delay grows larger with the addition of each agency that must submit an EIS.

To correct this situation, the NES Act would make the Commission the sole agency required by NEPA to prepare a detailed environmental impact statement in connection with an application for a pipeline certificate. The Commission would still be required to consult with and consider comments of other federal agencies, but the risk of multiple EIS's for the purpose of pipeline construction would be eliminated.

Related Rate Regulation Reform

As I emphasized earlier, the effectiveness of any certification reform is directly related to rate regulation reform. At present, pipeline operators must file with the Commission rate schedules for gas sales and transportation services. The Commission conducts an administrative proceeding to determine whether the rates are just and reasonable and not unduly discriminatory. The NES Act would eliminate rate filing requirements for pipelines constructed pursuant to the optional expedited certification procedure or the non-jurisdictional option, and sharply curtail the Commission's authority to regulate the rates charged by those pipelines.

There are two key elements in the proposed reform of rate regulation for pipelines constructed under optional expedited

certification or under the non-jurisdictional option. First, any rates, terms, and conditions mutually agreed to by such a pipeline and its customer will be deemed to be in compliance with the requirements of the Natural Gas Act. There is no need for Commission oversight of arms-length commercial transactions.

Of course, customers will not necessarily be able to get the rate they want in every instance. Here is where the second aspect of rate regulation comes into play.

After construction of the pipeline has been completed, there may be recourse to Commission regulation, in limited circumstances, if a customer's bona fide offer is refused by the pipeline. The person seeking transportation service could file a petition with the Commission requesting service at a not unduly discriminatory rate. The petitioner would be required to state the basis for asserting that it had made a bona fide offer to enter into a contract and that the pipeline's refusal to enter into that contract was unduly discriminatory. Pending the determination of a not unduly discriminatory rate, the Commission would issue an order, within 60 days of the filing of the petition, directing the pipeline to commence service on the terms sought by the petitioner, unless the Commission determines capacity is not available.

The pipeline has an opportunity to respond to such an order by asserting that its terms for the requested transportation are not unduly discriminatory. If such an assertion were made, service must still commence within 60 days of petitioner's filing, but on the pipeline's terms, subject to refund and interest. If it enters the proceeding, the burden of proof would be on the pipeline to demonstrate that any rate or charge in excess of that filed by the petitioner is not unduly discriminatory.

The Commission's power in such a rate review proceeding would be limited to ordering service at a rate that is not unduly discriminatory. The standard to be applied in making this determination is not the traditional cost-based, just and reasonable rate. Instead, the Commission would consider market conditions and, to the extent relevant, the entire range of transportation rates and services provided by the pipeline.

It is important to note that this system of regulatory protection is available to customers only subsequent to construction of the pipeline. Prior to construction, any customer's inability to obtain the contract he desires would not be subject to Commission review. This limit on regulation is a logical outgrowth of the proposition that, before it is

constructed, a pipeline cannot have market power sufficient to warrant regulation.

Rate Regulation Reform for Existing Pipelines

The NES Act would also provide transportation and sales rate deregulation options to existing pipelines, including holders of traditional certificates. All natural gas pipelines currently are required to file with the FERC cost and revenue data that are used by regulators to construct rates determined to be just and reasonable and not unduly discriminatory. This traditional cost-of-service rate regulation entails substantial administrative costs, not the least of which may be the costly delays that are imposed upon participants trying to react quickly to rapidly changing market conditions. Moreover, cost-of-service regulation blunts the incentives of regulated firms to innovate and to minimize their costs because they realize that regulators will automatically pass through their cost savings to customers in the form of lower rates in the future. Furthermore, by making future rates dependent upon actual revenues achieved, cost-of-service regulation has tended perversely to increase rates during times of soft demand and lower them during periods when demand has been strong.

Finally, this form of regulation requires regulators to assign common overhead costs to the various services provided by the regulated firm. Because such assignments have no economic significance, they produce significant inefficiencies, precluding regulated firms from charging rates more in line with the demands of the marketplace. Such distortions may be so severe (as they were prior to deregulation in the railroad industry) that they threaten the very existence of otherwise viable firms.

Although the FERC has of late been working to mitigate some of the more glaring of these deficiencies, the basic cost-of-service regulatory framework remains in place. The NES Act would enable existing pipelines to opt out of the current regulatory regime. First, pipelines covered by traditional certification procedures may elect to be treated like optional expedited certification pipelines, provided that they go through abandonment proceedings[1/] and provided that they agree to the two prerequisites of optional expedited certification -- foreclosure from challenging applications for

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1/ Existing pipelines and those that are built under the traditional certification route would have to obtain the Commission's approval before abandoning the operation of jurisdictional facilities or the provision of jurisdictional services. This is a statutory requirement at 15 U.S.C. 717f(b) that would not be affected by the NES Act.

competing pipelines and no inclusion of the costs of the pipeline in any rate filed with the Commission.

The attractiveness of this option is that it frees existing pipelines from the shackles of rate regulation and allows them to follow the same market approach to rates that is provided for pipelines authorized under optional expedited certification. Of course, the required abandonment proceedings would provide existing customers ample opportunity to protect themselves from adverse consequences of this shift in regulatory treatment.

Second, any pipeline constructed under traditional certification, optional expedited certification or section 311 authority would be able to petition for complete deregulation of its transportation or sales rates in a given market upon a finding by the Commission that the market in question is competitive and that the transportation or sales rates offered by the carrier in that market are not unduly discriminatory. Again, the burden of proof, as well as the burden of coming forward, would be on the pipeline. Once these determinations were made, the pipeline would be free to enter into commercially negotiated rates without any FERC oversight. Shippers unable to negotiate rates with these competitive pipelines would have no appeal to the Commission such as that

which exists for optional expedited or non-jurisdictional pipelines. Nevertheless, customers could contest the findings that their market is competitive and that the rates are not unduly discriminatory.

I must stress the importance of these reforms. Rate regulation reform must extend to existing pipelines. Without an option to convert to market-determined rates, a major portion of the natural gas industry would continue to be subject to rigid and inefficient regulation. Although the Commission already has taken important steps in this direction, a clear statutory mandate is needed. The absence of such a mandate could jeopardize the impact of the other NES reforms. As I observed earlier, the success of one reform initiative is intertwined with the implementation of the others. Simply put, increasing the efficiency of the existing system is a necessary complement to the reduction of regulatory barriers to new construction.

Conclusion

Development of the natural gas industry can reduce the nation's vulnerability to oil price shocks in a manner that is consistent with our overall energy goals. Natural gas is clean and abundant. Its potential will only be realized, however, if

regulatory impediments to the functioning of natural gas markets are removed. Without legislative action to remove these regulatory impediments, efficient expansion of the natural gas industry will be impossible, and the potential of natural gas to reduce our vulnerability to oil price shocks will be needlessly constrained.

The Department of Justice heartily endorses the enactment of the National Energy Strategy Act, which we view as a necessary step to reducing the nation's vulnerability to oil price shocks. The reforms and initiatives embodied in the NES Act are a responsible and rational approach to dismantling the regulatory barriers that impede the development of the natural gas industry. Fortunately, throughout the NES process, the Department of Energy and the Department of Justice have shared the firmly held view that the natural gas industry is long overdue for deregulation. Apparently the industry is coming to share this view as well. Stephen Wakefield, General Counsel of the Department of Energy stated succinctly in recent testimony before the Senate Energy Committee that: "The [natural gas] industry has reached the stage where it will react more favorably to the stimulus of competition rather than to the dead hand of regulation." Most importantly, consumers will benefit when competition is allowed to yield market determined results. President Bush has directed his Administration to

rediscover and apply this fundamental principal of the nation's economic system, and the NES Act is an outstanding example of the benefits that the nation will derive in implementing the President's directive.

Thank you for your attention.