STUDENT NOTE

THE MARKETING AFFILIATE RULE OF ORDER NO. 497: TO WHOM DOES IT APPLY?

I. INTRODUCTION

A. Background Leading to Order No. 497

Due to the emergence of the "gas bubble"[1] and special marketing programs, a spot market for natural gas developed beginning in 1983.[2] In response, many pipeline companies have established affiliated marketing companies to market non-dedicated or released gas.[3] Most pipelines have an affiliated marketing company as well as system supply and are thus characterized by dual distribution.[4]

The maturing of the natural gas industry and the phased removal of wellhead pricing under the Natural Gas Policy Act of 1978 (NGPA)[5] have brought major changes to the natural gas industry over the past decade.[6] One significant change has been the evolution of natural gas into a distinct economic commodity, separate from transportation, storage, and other related services.[7] The result has been the creation of a competitive spot market for gas, with brokers, marketers, and producers competing for sales, often without the requirement of prior regulatory approval as to market entry, exit, or price.[8] In addition, the development of a nationwide pipeline grid provides nationwide access to gas supplies in cases where there is non discriminatory

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1. "Gas bubble" is the term applied to the release to the market of substantial quantities of gas previously withheld from the market by owners anticipating deregulation, after said deregulation occurred. As a result, the supply of gas exceeded demand under the price structure of the early 1980's. WILLIAMS & MEYERS, MANUAL OF OIL AND GAS TERMS 393 (7th ed. 1987).

2. D. Teece, Vertical Integration and Dual Distribution in the Natural Gas Industry: Causes and Consequences 8 (December 29, 1986) (filed by Tenneco, Inc. in response to the FERC's request for public comment to Order No. 497). Prior to the passage of the Public Utilities Holding Company Act of 1935, 15 U.S.C. §§ 79-79(z) (1982), sixteen holding companies controlled almost half of all gas transmission and distribution in the United States. Nine holding companies had 80% of the total of the limited interstate pipeline mileage in place at the time. Teece, *supra* note 2.

3. Teece, *supra* note 2. Spot gas is sold by affiliated marketing companies of the pipelines, by affiliated marketing companies of producers, and by independent marketers who are not affiliated with other natural gas interests. All gas is transported to the customer via pipelines which need not be affiliated with the marketing company. *Id.*

4. *Id.*

5. Natural Gas Policy Act of 1978 (NGPA), 15 U.S.C. §§ 3301-432 (1982).

6. Notice of Inquiry, *Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines*, IV F.E.R.C. Stats. & Regs. ¶ 35,520 (1986), 51 Fed. Reg. 41,982 (1986) [hereinafter NOI] (page references are to the Federal Register cite).

7. 51 Fed. Reg. at 41,983. This change was in large part engendered by the decision of Congress to remove both price and non-price regulation from most first sales of natural gas under the NGPA. *Id.*

8. *Id.*

access to transportation facilities.[9]

The Federal Energy Regulatory Commission (FERC) responded to these changes in the natural gas industry by promulgating Order No. 436,[10] which seeks to implement the anti discrimination provisions of the Natural Gas Act (NGA)[11] in the context of gas transportation by instituting a broad program for open access gas transportation in interstate commerce.[12] The rules set out in Order No. 436 were intended to define and identify the prohibited discriminatory conduct, to minimize the use of market power to influence the gas markets, and to stimulate broader access to gas transportation facilities by producers and purchasers of gas.[13]

Despite the promulgation of Order No. 436, allegations of discrimination not explicitly anticipated by the aforementioned rules have been made in numerous cases,[14] as well as in a number of petitions for rulemaking.[15] In light of these allegations, the FERC issued a notice of inquiry (NOI) in 1986[16] to ascertain whether the potential for abuse reflected in the petitions and in existing cases are actual anticompetitive barriers that should be remedied by a generic rule.[17]

B. Purpose of Order No. 497

The FERC issued a notice of proposed rulemaking (NOPR)[18] in response to the comments received to the NOI wherein it stated its view that no industry-wide standards of conduct concerning relations with affiliated and non-affiliated marketing entities were being observed and that anticompetitive effects could be occurring.[19] In the NOPR, the FERC identified three areas of

9. *Id.*

10. Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol,* [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,665 (1987), 50 Fed. Reg. 42,409 (1985) (codified at 18 C.F.R. § 284.9 (1988)) [hereinafter Order No. 436] (page references are to the Federal Register cite).

11. Natural Gas Act (NGA), 15 U.S.C. §§ 717(c), (d) (1982).

12. Order No. 436, *supra* note 10, at 42,408. The FERC found that "transportation tariffs, terms and conditions, including but not limited to prices, minimum volume or operational requirements, or schedules that are designed to favor pipeline affiliates over non-affiliated shippers are preferential or unduly discriminatory practices." *Id.* at 42,434.

13. NOI, *supra* note 6, at 41,982. The FERC also established reporting requirements with regard to selective discounting to limit the potential for affiliate transaction abuse, and required identification of the spread between chargeable and actually charged rates for shippers and identification of any corporate affiliation with the shipper. *Id.* at 41,983; *see also* 18 C.F.R. 284.7(d)(5) (1988).

14. NOI, *supra* note 6, at 41,983.

15. *Id. See* Arkla Expl. Co., 37 F.E.R.C. ¶ 61,011 (1986); Southern Natural Gas Co., 36 F.E.R.C. ¶ 61,401 (1986); Tenneco Oil Co., 36 F.E.R.C. ¶ 61,399 (1986); Independent Petroleum Ass'n of Mountain States, 36 F.E.R.C. ¶ 61,282 (1986); Southern Natural Gas Co., 36 F.E.R.C. ¶ 61,275 (1986); Texas Gas Transm'n Corp., 36 F.E.R.C. P 61,274 (1986); Mountain Fuel Resources, Inc., 36 F.E.R.C. ¶ 61,150 (1986); ANR Pipeline Co., 35 F.E.R.C. ¶ 61,400 (1986); Northern Natural Gas Co., 20 F.E.R.C. ¶ 61,040 (1982).

16. NOI, *supra* note 6, at 41,982.

17. *Id.* at 41,983.

18. Notice of Proposed Rulemaking, *Inquiry into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines,* [Proposed Regs. 1982-1987] F.E.R.C. Stats. & Regs. ¶ 32,445, 52 Fed. Reg. 21,578 (1987) [hereinafter NOPR] (page references are to the Federal Register cite).

19. 52 Fed. Reg. at 21,579.

special concern in the context of pipeline marketing affiliates:

(1) some pipelines may be serving their affiliates faster than non-affiliates;
(2) some affiliates may have access to confidential information regarding availability of capacity and other issues; and
(3) some pipelines may be selectively enforcing operating provisions against non-affiliated shippers while not holding affiliates to the same standards.[20]

Serious issues also exist concerning other anticompetitive activities, such as the abuse of selective discounting under Order No. 436, the selective application of balancing penalties, and other discriminatory use of tariff provisions and requirements such as those related to gas quality and volume requirements.[21] Order No. 497[22] was promulgated to alleviate these general areas of potential abuse between interstate pipelines and their marketing affiliates.[23]

C. *Statement of Rule in Order No. 497*

Although it has been argued by some pipelines that Order No. 497 is unnecessary,[24] the FERC remained convinced of the need for a general rule to establish standards of conduct governing relationships between pipelines and their marketing affiliates, and to require pipelines and their affiliates to provide information to allow the FERC and participants in the natural gas markets to monitor those relationships in order to prevent anticompetitive abuses.[25] The

20. *Id.* The proposed rule set forth standards of conduct for interstate pipeline/marketing affiliate relations in both tariff-related and non tariff-related areas. *Id.* at 21,580. The NOPR also outlined the FERC's preliminary assessment of what it considered to be prohibited practices. *Id.* at 21,579. The FERC also proposed reporting requirements to provide data that would reveal where anticompetitive practices were occurring and suggested remedies for violation of either the proposed substantive standards or the reporting requirements. *Id.* The FERC also put in place an informal Enforcement Task Force to process existing and future complaints quickly and established a system for resolving disputes related to marketing affiliates without the time-consuming formal complaint and hearing processes proposed in the NOPR. *Id.* at 21,579 n.4.

21. *Id.* at 21,579. The FERC is concerned with the discriminatory application and anticompetitive effect of the flexibility of selective discounting and waiver of tariff requirements under certain regulations. *Id.*

22. Order No. 497, *Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines*, [Regs. Preambles] III F.E.R.C. Stats. & Regs. ¶ 30,820, 53 Fed. Reg. 22,139 (1988) (to be codified at 18 C.F.R. § 161) [hereinafter Order No. 497] (page references are to the Federal Register cite).

23. NOPR, *supra* note 18, at 21,579.

24. Order No. 497, *supra* note 22, at 22,140. Some pipelines argue that Order No. 497 is unnecessary for three primary reasons: (1) There have been relatively few cases of anticompetitive behavior in the relationship between pipelines and their marketing affiliates; (2) The "anecdotal" problem situations occurred mainly when pipelines were adjusting to the new conditions created by the FERC's Order No. 436 initiative; and (3) Pipeline transactions with their affiliates were primarily designed to ease their take-or-pay burdens by developing new means for finding markets for their gas. *Id.* These pipelines contend that these factors indicate that abuses in the pipeline/marketing affiliate relationship are not widespread, and in any event, that they are declining as pipelines adjust to new conditions and ease their take-or-pay obligations. *Id.* In contrast, several independent marketers and other commentors argued that the proposed rule did not go far enough and that certain structural remedies are necessary, ranging from requiring an outright physical separation between the pipeline's staff and the staff of the marketing affiliate to prohibiting dealings between the pipeline and its marketing affiliate altogether ("divorcement"). *Id.*

25. *Id.* Some pipelines conceded the value of a clearly established code of conduct to guide behavior, rather than having to operate without established standards and running the risk that specific practices would later be found to be unlawfully discriminatory. *Id.*

FERC concluded that a rule was needed as long as pipelines continue to have economic incentives to show undue preferences toward their marketing affiliates.[26]

The FERC proposed standards of conduct and reporting requirements that would apply to any interstate natural gas pipeline that is affiliated with a marketing or brokering entity.[27] To determine affiliation, the definition in section 2(27) of the NGPA is to be applied.[28] This subsection provides that "[t]he term 'affiliate,' when used in relation to a person, means another person which controls, is controlled by, or is under common control with, such person."[29] The FERC believed a ten percent voting interest was a prima facie indicator of sufficient control to satisfy the NGPA definition of affiliate.[30] However, the FERC made the application of the test flexible enough to encompass exceptions in individual cases.[31]

The FERC will also examine, on a case by case basis, situations in which a pipeline and a marketer are not technically affiliated but in which the pipeline has a beneficial interest in a marketer, or a third party has beneficial interests in both a marketer and a pipeline. When beneficial interests are found, the FERC may find that the entities are not dealing at arms length because their

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26. *Id.*

27. *Id.* at 22,141. The FERC retained "first sale" status of sales by pipeline marketing affiliates. This would exempt affiliate sales of certain NGPA categories of gas from NGA jurisdiction. The FERC believes that by regulating the pipelines, regulation of the marketing affiliates would be unnecessary. *Id.* at 22,142. The FERC adopted tariff-related standards of conduct requiring:

(1) pipelines with marketing affiliates to implement all tariff provisions in a uniform manner;
(2) enforce tariff conditions strictly as to marketing affiliates, as well as to non-affiliates;
(3) refrain from providing marketing affiliates with a higher scheduling and curtailment priority for less essential service that would ordinarily have a lower priority;
(4) specify in their tariffs what information and format constitute a valid request for transportation service by shippers;
(5) specify in their tariffs a specific period of time or milestones for processing requests and process all pending requests in accordance with these specifications; and
(6) refile their tariffs to meet these standards.

Id. The rule also established non-tariff-related standards of conduct, including a proposed disposition of transportation requests and processing of requests, a prohibition against revealing confidential information by a pipeline to its marketing affiliate, and a prohibition against revealing information filed with transportation requests. Other standards include limitations on the dissemination of capacity information, requirements that employees of the pipelines and marketing affiliates function as independently as possible, prohibition against tying an agreement to release gas subject to take-or-pay relief to an agreement to obtain services from an affiliate, and a requirement of confirming sales of released gas if asked. The rule also requires that a log be kept showing all request for transportation and their disposition in accordance with applicable FERC regulations and also to provide written procedure showing how prohibited practices have been eliminated. *Id.* at 22,146-50. Pipelines must file information on transportation requests in which a marketing affiliate is involved that have commenced 30 days or more earlier. *Id.* at 22,150.

28. *Id.* at 22,141.

29. 15 U.S.C. § 3301(27).

30. Order No. 497, *supra* note 22, at 22,142. The FERC believed a 10% voting interest may create enough financial interest to influence a pipeline's transactions with a marketing affiliate. *Id.*

31. *Id.* The FERC concluded that a strictly numerical test may be too restrictive to encompass the many different kinds of corporate arrangements that result in common financial interests. *Id.* The FERC thus adopted a definition of control which emphasized the authority to direct or cause the direction of the management policies of a business entity rather than a percentage of the ownership or voting rights. *Id.*

economic interests coincide.[32] One instance in which an entity was found to have had a beneficial interest in the marketer was when a buyer of natural gas agreed to a contract amendment that entitled him to a fifty percent "payback" of the increase in price over the original contract price.[33] Thus, the FERC is concerned that when the economic interests of technically non-affiliated entities coincide, the pipeline may give the marketer preferential treatment.[34] In such a case, the FERC may subject those entities to the requirements of the rule in an individual proceeding or other provisions of the statutes and regulations it administers.[35] The FERC concluded that the rule should cover all transactions engaged in by pipeline marketing affiliates, no matter what the role in a particular transaction, as the possibility of preferential treatment exists whether a marketing affiliate is involved in a transaction as a shipper, a broker, or in some other role.[36]

The FERC set down standards of conduct and reporting requirements to be followed by affiliates of a pipeline who market or broker gas. The FERC did not give a stricter definition of a marketing affiliate for fear that the definition would be too restrictive to encompass all different types of marketing and brokering arrangements.[37] By failing to give a hard and fast definition under Order No. 497, the FERC has opened the door to potential abuse from over inclusiveness and under inclusiveness. The present definition would allow for any affiliate engaged in the sale of gas to be subject to the rule, including local distribution companies and intrastate pipelines, when the entities are not subject to regulation under the NGA or the NGPA. On the other hand, an interstate pipeline could evade regulation by selling its gathering system to its marketing affiliate and claiming that, since the affiliate was a gatherer, the rule did not apply. This also is not desirable because there would still be an opportunity for anticompetitive activities in the natural gas sales and transportation markets. The question remains as to whether the FERC's failure to strictly define "marketing affiliate" allows for further potential abuse in the natural gas sales and transportation markets.

II. Analysis

A. *Marketing Affiliate: The FERC's Non-Definition*

The FERC did not give a strict definition for "affiliate" other than using the definition as stated in NGPA section 2(27). Instead it set out the test to determine affiliation under 2(27) as follows:

> A 10 percent voting interest shall be a prima facie indication of sufficient control to meet that definition, although a lesser percentage may be determined, on application, to amount to sufficient control in a particular case.[38]

32. *Id.*
33. *See* Colorado Oil and Gas Conserv'n Comm'n, 26 F.E.R.C. ¶ 61,267 (1984).
34. Order No. 497, *supra* note 22, at 22,142.
35. *Id.*
36. *Id.*
37. *Id.* at 22,141.
38. NOPR, *supra* note 18, at 21,580 n.10.

Several commentators to the NOPR asked the FERC to more precisely define marketing or brokering entity, arguing that the term "marketing affiliate" was too broad.[39] These commentators argue that the term can include affiliated gas producers, affiliated local distribution companies, and affiliates such as gathering companies, intrastate pipelines, joint venture partnerships, and single purpose "project" affiliates since these affiliates market and broker natural gas.[40] These commentators contend that there is not an economic incentive for the pipeline to favor the transaction, thereby eliminating the motive for potential abuse of the pipeline-affiliate relationship.[41]

The FERC did not agree that these entities should be excluded. The FERC recognized that the potential for abuse of the pipeline-affiliate relationship exists whether the gas being transported is owned, brokered, or sold by a pipeline's affiliate.[42] Hence, the FERC is concerned with a transaction conducted on a pipeline that benefits the pipeline or the corporate group of which it is a part, as there is an incentive for the pipeline to favor the transaction.[43] Thus, the FERC "is not exempting any affiliate of a pipeline that markets or brokers gas, unless the pipeline does not conduct any transactions with the affiliate."[44] The FERC believes this approach is preferable to strictly defining marketing or brokering entity as an inclusive definition may be too restrictive to include all the different types of marketing and brokering arrangements.[45] However, the FERC concluded that Order No. 497 was not applicable to pipelines without marketing affiliates or to pipelines with marketing affiliates if their activities were properly "divorced," as there would not be any potential for abuse of the pipeline-affiliate relationship in these cases.[46]

B. *Industry Reaction to the FERC's "Definition"*

By failing to strictly define the term "affiliate" in Order No. 497, the FERC opened the door for any affiliate engaged in the sale of gas to be subject to the rule unless properly "divorced." Opponents have called the rule a victory for independent marketers seeking "to use the regulatory machinery to gain a competitive advantage."[47] Opponents also contend that the rule subjects many industry entities to another layer of indirect regulation when the entities are already subject to regulation by other parties.[48] For example, in

39. Order No. 497, *supra* note 22, at 22,141.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

44. *Id.*

45. *Id.* Commentors believe that the rule should also apply to additional entities such as large producers and their marketing affiliates and to all marketing entities so that costs of compliance would be the same for all. The FERC said that they will not expand the rule to cover those entities because the FERC does not have jurisdiction over them, or very limited jurisdiction. The FERC did leave the door open to future expansion of the coverage of the rule by stating that this decision was made in light of the absence of abusive practices and the availability of complaint procedures for aggrieved parties. *Id.*

46. *Id.* at 22,142.

47. *Combatants ask FERC: To Whom Does Marketing-Affiliate Rule Apply?*, *Inside F.E.R.C.*, July 11, 1988, at 9 [hereinafter *Marketing-Affiliate Rule*].

48. *Id.*

Texas, interstate pipelines are under regulation by the Railroad Commission.[49] Opponents argue that the independent marketers have everything to gain from seeing their competitors regulated while they are not subject to regulation.[50] Opponents charge that by allowing independent marketers and brokers to go unregulated and impeding the intracorporate flow of information inherent in an efficient, integrated firm, the rule produces anticompetitive effects rather than protecting competition.[51]

Proponents argue that the rule was a "sincere attempt" by the FERC to eliminate anticompetitive behavior but add that anything less than full operational separation will not be fully effective.[52] The comments of several major industry groups are set forth below.

(1) Major producers urged the FERC to issue regulations to minimize pipeline-affiliate abuses that stifle competition.[53] Most producers recommended increased reporting requirements for affiliated transactions, prohibition of disclosure of inside information by interstate pipelines to their marketing affiliates, expedited complaint procedures and express prohibition of certain activities by interstate pipelines in favor of their marketing affiliates.[54] Others argued that while some regulation was necessary, the reporting requirements should not go so far as to require disclosure of proprietary information.[55]

(2) Independent producers generally support the idea of further regulation in this area and only ask for fair access to the transportation markets.[56] However, from that point of agreement the comments vary diversely. These comments range from no regulation of marketing affiliates and the requirement of free disclosure of affiliate contracts, operating conditions and capacity availability, to the promulgation of a strong set of "per se" rules. The time consuming case-by-case complaint approach could be avoided by the establishment of coherent guidelines.[57] One commentator sums it up by saying that "whatever action the [FERC] decides to take, it must make [the rule] clear and concise to provide the regulatory stability needed to plan energy related exploration and production activities."[58]

(3) Many Interstate pipelines argue that existing regulations are sufficient to correct any perceived abuses and that any additional regulation is unnecessary.[59] Other commentators believe the FERC should promulgate only the minimum rules necessary to level the playing field.[60] Virtually all

49. *Id. See* TEX. NAT. RES. CODE ANN. § 111.012 (Vernon 1978).

50. *Marketing-Affiliate Rule, supra* note 47, at 9.

51. *Id.*

52. *Id.*

53. NOPR, *supra* note 18, at 21,590.

54. *Id.* The prohibited transactions would include preferences for capacity, for discounted rates, and for interruption of transportation. *Id.* at 21,590 n.4.

55. *Id.* at 21,590.

56. *Id.* at 21,591.

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.* at 21,591 n.28.

interstate pipelines agree that a good faith adaptation to the recently promulgated Order No. 436 combined with the existing regulation would be sufficient to safeguard against the potential abuse set out in the NOI.[61] There commentators generally believe that the FERC should continue to implement Order No. 436, refrain from regulating marketing affiliates, and concentrate on the industry's take-or-pay problems.[62]

(4) Intrastate pipeline commentors emphasize that the regulation should be applicable only to interstate pipelines.[63] However, these commentors feel that a "per se" rule regarding marketing affiliates of interstate pipelines would be unnecessary and inefficient, and hinder a company's ability to compete.[64]

(5) The affiliated marketing commentors unanimously believe that affiliated pipeline marketing affiliates provide an invaluable service to consumers and the natural gas industry.[65] These commentors also feel that any problems are a result of the implementation of Order No. 436 and that any new regulation is unnecessary.[66] Some commentors believe that complaints should be handled on a case-by-case basis, while others feel that any regulation would confer an unfair competitive advantage upon their unregulated competitors.[67] In general, the majority of these commentors believe that the regulatory framework already in place is sufficient, and these perceived abuses will correct themselves as Order No. 436 is given time to take effect.[68]

(6) The independent marketers have no consensus of ideas regarding regulation of marketing affiliates, but they have described alleged abuses and requested certain remedies.[69] These requests range from the simple requirement of making pipelines utilize unaffiliated pipelines to transport their transactions to a "nine-point program" of recommended remedies that encompasses nearly all of the comments made by other independent marketers.[70] One representative commentor perceived the abuses as real and

61. *Id.* at 21,592.
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.* at 21,594.
66. *Id.*
67. *Id.*
68. *Id.*
69. *Id.* at 21,595.
70. *Id.* The "nine-point program" consists of the following suggestions:

(1) The FERC must effectively ban the abuse of material inside information by requiring that marketing affiliates be 'held separate' from the pipeline. . . .

(2) Marketing companies affiliated with an interstate pipeline must be limited to less than fifty percent of the total volumes transported by that pipeline for others.

(3) Selective rate discounting to benefit a marketing affiliate must be prohibited.

(4) The marketing affiliate's preferred access to released gas must be removed by requiring public notice of the intent to release and by enforcing a three month "cooling off" period in which the pipeline would be precluded from transporting any released gas on behalf of its marketing affiliate. . . .

(5) Pipelines must be prohibited from providing firm transportation for their marketing affiliate until after the customers' CD reduction and conversion requests are filed with the FERC.

(6) All tie-in arrangements involving pipeline transportation must be banned.

requested that: (a) an integrated program of regulations to control and monitor the conduct of, and business relationships between, pipelines and their affiliated marketers be established; (b) the program be clearly spelled out in a FERC policy statement as well as in specific regulations; (c) the program be enforced and the enforcement provisions be given adequate teeth; and (4) the regulatory program be imposed directly on pipelines transporting natural gas in interstate commerce, not on their marketing affiliates.[71] Independent marketers are in favor of regulation of the pipeline-affiliate relationship, but few suggest divestiture is appropriate except as a last resort.[72]

Taking the comments from the various industries as a whole, it is clear that those who are a part of the pipeline-affiliate relationship are against any further regulation of the relationship. Entities considered to be outside of the relationship are in favor of more regulation to eliminate alleged abuses occurring within the pipeline-affiliate relationship.

C. *Past Interpretation Involving Marketing Affiliates*

One case, in different stages of the hearing process, has addressed the issue of what constitutes a marketing affiliate.[73] The first proceeding that addressed this issue was a request for a declaratory order filed by Northwest Central Pipeline Corporation (Northwest).[74] In this case, Northwest had gas purchase contracts with a partnership consisting of Amoco Production Company (Amoco) as the general partner, and the Wamsutter Limited Partnership (WLP) and the Moxa Limited Partnership (MLP) as limited partners.[75] In early 1981, Northwest amended the contracts with the partnership to bring them within the requirements of FERC Order No. 99,[76] which provides that contracts for tight information gas must contain a negotiated contract price.[77] The amendments also made the negotiated contract price retroactive to July 16, 1979.[78] The partnership required Northwest to pay incentive prices for

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(7) The FERC should impose an express obligation on interstate pipelines to treat all marketers in a fair, commercially even-handed manner.

(8) "Sweetheart deals" or "cross favoritism" among pipelines must be prohibited.

(9) The FERC must put an end to all operational favoritism shown to affiliates, whether in the selective enforcement of contract quality specifications, transportation request forms, contract minimums or any other type of operational preference.

Id.

71. *Id.*

72. *Id.*

73. Midwest Gas Users Ass'n v. FERC, 833 F.2d 341 (D.C. Cir. 1987); Midwest Gas Users Ass'n v. Northwest Cent. Pipeline Corp., 34 F.E.R.C. ¶ 61,301 (1986); In re Northwest Cent. Pipeline Corp., 32 F.E.R.C. ¶ 61,471 (1985).

74. 32 F.E.R.C. ¶ 61,471, at 62,068.

75. *Id.* at 62,070.

76. Order No. 99, *High-Cost Natural Gas Produced from Tight Formations,* [Regs. Preambles 1977-1981] F.E.R.C. Stats. & Regs. ¶ 30,183, 18 C.F.R. § 271. 703 (1988).

77. 32 F.E.R.C. ¶ 61,471, at 62,070. Negotiated contract price is defined as "any price established by a contract provision that specifically references the incentive pricing authority of the [FERC] under section 107 of the NGPA, by a contract provision that prescribes a fixed rate, or by the operation of a fixed escalator clause." *Id.*

78. *Id.*

certain production, which is allowable for affiliated entities under the NGPA.[79] The issue concerning marketing affiliates was whether the partnership and Northwest were affiliated, and if so, whether the affiliated entities limitation of the NGPA or the fraud/abuse limitation on passthrough were applicable to the amendments so as to bar their effectiveness.[80] The FERC held that although it was a close question as to whether the partnership and Northwest were affiliated, it held they were not because it could not be said that the partnerships as separate entities met the section 2(27) affiliation test.[81] The FERC stated that "[t]here [was] authority that the entity concept cannot be invoked to achieve an unjust result, and may be disregarded as individuals in order to prevent injustice and fraud."[82] The FERC reserved the right to reassess the issue of whether the partnership "entity" should be disregarded after the conclusion of the related court proceedings.[83] The FERC also declined to institute proceedings on the fraud/abuse issue since these are also grounded in the allegation of partnership affiliate self-dealing.[84]

The next related decision was *Midwest Gas Users Association v. Northwest Central Pipeline Corp.*,[85] which was a request for rehearing on Northwest's request for a declaratory order. On rehearing, the FERC found that Northwest could not have exercised control over the partnership since Amoco was serving in the capacity of a general partner, which carries with it full, exclusive, and complete control of management and operations of the partnership.[86] The parties requesting the rehearing, however, argued that Northwest had control over the partnership through the contribution of capital and through participation in the decision-making vis-a-vis its right to reject drilling plans of the general partner.[87] The FERC addressed these points by saying that limited partners always contribute capital and that Northwest's authority to consult does not indicate control per se.[88] The FERC stated that since Northwest could only act in a limited capacity and only through the general partner, the entities could not be considered affiliates.[89] Thus, the rehearing petitions were effectively denied by the FERC's refusal to change its decision regarding the affiliation of the entities.

The most recent proceeding in this line of authority is *Midwest Gas Users Association v. FERC*,[90] which was a petition for review of the FERC's previous orders in this line of cases. In this case, the District of Columbia Circuit found "the [FERC's] analysis to be too formalistic to satisfy the goal of pro-

79. *Id.* at 62,072.
80. *Id.* at 62,070.
81. *Id.* at 62,072.
82. *Id.*
83. *Id.* at 62,073.
84. *Id.*
85. Midwest Gas Users Ass'n v. Northwest Cent. Pipeline Corp., 34 F.E.R.C. ¶ 61,301, at 61,546 (1986).
86. *Id.* at 61,551.
87. *Id.*
88. *Id.*
89. *Id.*
90. Midwest Gas Users Ass'n v. FERC, 833 F.2d 341 (D.C. Cir. 1987).

tecting consumers from self-dealing."[91] The court found that when the FERC found that the entities were not affiliated, it was automatically assumed that the entities had bargained at arm's-length.[92] The court found that the use of the affiliate test as the sole basis for determining arm's-length transactions was improper as the "FERC's test fails to deal with transactions between technically nonaffiliated parties that nevertheless defy market forces and that could permit natural gas companies to charge exploitative prices."[93] The court stated that by failing to test whether the transaction was at arm's-length, the FERC failed to recognize that all parties would be benefitted by the pipeline charging the higher "incentive" price.[94] The motivations of, and alliances between, the sellers and the buyers would have been determinative of whether an arm's-length transaction was involved.[95] Since the economic interests of the buyer coincided with that of the seller, the court held that an arm's-length transaction could not have occurred.[96]

The court's decision was a statement to the FERC that it should not rely solely on the definition as stated in the NGPA to determine affiliation.[97] The court proposed that the FERC add a second prong to the affiliation test to include technically nonaffiliated entities that are not bargaining at arm's-length.[98]

It is clear that the FERC took that advice in determining the test for affiliation under Order No. 497. The test for affiliation under Order No. 497 is the same as the test set out in section 2(27) of the NGPA,[99] with the exception that the FERC also included enough flexibility in the test to encompass technically nonaffiliated entities whose economic interests coincide. Although it should be recognized that the FERC decided not to give a strict definition to the term "marketing affiliate" because no strict definition is flexible enough, the FERC will still need to more clearly define what it considers to be a marketing affiliate as long as the parties to be regulated are unclear as to whether they are subject to Order No. 497.

III. ALTERNATIVES

Should the FERC decide that defining "marketing affiliate" would be too restrictive and prefer to keep a general definition, alternatives to a clearer definition need to be considered. These alternatives could provide alternatives to clarifying the definition while eliminating the preferential treatment of marketing affiliates. Several alternatives will be considered in turn.

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91. *Id.* at 353.
92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.* at 354.
96. *Id.*
97. *Id.*
98. *Id.* at 355.
99. 15 U.S.C. § 3301(27).

A. *Open Season*

This alternative would entail providing an access period open for ten days before a pipeline could become or resume status as an open access transporter, apply for any other significant transportation authorization, or announce the release of significant gas volumes.[100] This type of program would ensure equitable treatment for all producers because all requests for transmission received in that ten day open access period would be considered received at the same time, thus preventing the pipeline's marketing affiliates from "queuing up" in advance of the formal announcement by the pipeline.[101] This would give all parties interested in transportation an equal claim on the transportation to be offered—and prevent preferential treatment to the transporter's marketing affiliate.[102]

The FERC has used the open season idea in individual proceedings to achieve access to the capacity being offered.[103] The use of open season is intended to counteract any unfair advantage a marketing affiliate might have from receiving advance notice of a pipeline's intent to seek certain transportation authorizations.[104] The FERC will continue to use open season on a case by case basis.[105]

This alternative does not eliminate all potential abuse of the pipeline-affiliate relationship. Even though the pipeline would have to serve their affiliates on the same basis as other shippers, there could still be discriminatory use of tariff provisions and requirements and the use of selective discounting to favor the affiliate.

B. *Dual Approach to Pipeline Marketing Affiliates*

This alternative would prohibit a pipeline not subject to Order No. 436 from having marketing affiliates and allow pipelines subject to Order No. 436 to have them.[106] Proponents argued that a pipeline should be rewarded for taking the increased risks of becoming an open access transporter and that a pipeline should not be allowed the full benefits of competition via a marketing affiliate until it has accorded its customers the benefits of competition by

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100. Order No. 497, *supra* note 22, at 22,153.

101. *Id.*

102. *Id.*

103. *See, e.g.*, Pacific Gas Transm'n Co., 40 F.E.R.C. ¶ 61,193 (1987). In *Pacific Gas Transm'n*, the FERC found that the use of a lottery system to set up the initial queue of simultaneously filed requests was fair in that it gave all interested shippers equality of access to the pipeline and eliminated the possibility that shippers with close ties to Pacific Gas Transmission Co. could use advance knowledge to gain a high position on the queue. *Id.* at 61,618. The FERC is requiring the use of a queue in the open-season approach when it is found that the queue has been defective because certain shippers were made privy to inside information. *Id. See also* Tennessee Gas Pipeline Co., 40 F.E.R.C. ¶ 61,194 (1987), in which the FERC allowed the use of a pro rata mechanism for the allocation of capacity on an initial queue, as long as such procedure is implemented in a fair manner and does not result in undue discrimination or unfair competition. *Id.* at 61,639.

104. Order No. 497, *supra* note 22, at 22,153.

105. *Id.*

106. *Id.*

becoming an open access transporter.[107] Opponents argued that there was no rational basis for the prohibition against pipelines not subject to Order No. 436 and that such a prohibition would undercut the voluntary nature of the open access transportation program..[108] They claim that the FERC should be concerned with anticompetitive practices not only with respect to open access pipelines but with respect to non-open access pipelines as well.[109] The FERC believes that mandating open access status would not resolve its concerns over preferential treatment a pipeline may give its marketing affiliate, but it has conditioned the ability to engage in selective discounting on the pipeline being an open access transporter.[110]

C. Divorcement

Another proposed alternative has been the idea of divorcement, that is, the physical separation of ownership and control of pipelines from that of marketing entities. The result being that there would be no opportunity for preferential treatment since there would be no opportunity for information to leak to the separate entity. This alternative seems unduly harsh and impractical and would work to reduce competition and lessen the benefits of vertical integration.[111] This alternative would eliminate the efficiency acquired in an integrated firm by the unnecessary separation of personnel.[112] Proponents argue that divorcement is the only effective remedy for undue discrimination by a pipeline in favor of its marketing affiliate.[113] However, the FERC believes that this alternative should be limited in its use as a remedy for extreme, habitual instances of preferential treatment of a marketing affiliate, as it believes that the existing rule in Order No. 497 is sufficient to keep abuses of the pipeline-affiliate relationship from occurring.[114]

IV. CONCLUSION

At present, Order No. 497 applies to all affiliates of a pipeline that markets or brokers natural gas, unless that pipeline does not conduct any transactions with the affiliate.[115] However, proponents and opponents alike argue that the term needs to be more strictly defined, although for different reasons.[116] The FERC took steps toward clarifying the definition by adopting the second prong of the affiliation test as set down by the court in *Midwest*.[117] However, by failing to strictly define "marketing affiliate," the FERC has left

107. *Id.* at 22,154.
108. *Id.* at 22,153.
109. *Id.* at 22,154.
110. *Id.*
111. *Id.*
112. *Marketing-Affiliate Rule, supra* note 47, at 9.
113. Order No. 497, *supra* note 22, at 22,154.
114. *Id.*
115. *Id.* at 22,141.
116. *Marketing-Affiliate Rule, supra* note 47, at 9.
117. Midwest Gas Users Ass'n v. FERC, 833 F.2d 341, 355 (D.C. Cir. 1987).

all affiliates engaged in the sale of natural gas wondering if they are subject to the regulations of Order No. 497.[118]

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118. *Marketing-Affiliate Rule, supra* note 47, at 9.