

# Report of the Judicial Review Committee

## I. INTRODUCTION

In 1991 the appellate courts issued a number of significant decisions involving the federal regulation of the energy industries. This year's report focuses on four areas:

1. The scope of Federal Energy Regulatory Commission (Commission or FERC) jurisdiction under sections 1(b), 4 and 5 of the Natural Gas Act (NGA),<sup>1</sup> over the interstate transmission of natural gas and the rates charged by "natural gas companies" for that service;
2. The resolution of lingering wellhead ceiling price issues and the implementation of the Wellhead Decontrol Act of 1989;<sup>2</sup>
3. Evolving issues of open-access for qualifying facilities and end-users on electric rate facilities; and
4. Administrative law questions raised by the requirement that rules be placed in effect only after notice and an opportunity for comment.

The report is not a comprehensive review of every energy decision issued in 1991, but focuses on several interesting questions which will have an impact on future regulatory cases.

## II. NATURAL GAS ACT JURISDICTION ISSUES

In 1991, the Eighth Circuit affirmed the Commission's assertion of jurisdiction over gathering.<sup>3</sup> The court of appeals found that sections 4 and 5 of the NGA,<sup>4</sup> provide the Commission with "explicit" authority to regulate gathering,<sup>5</sup> notwithstanding the express language of section 1(b),<sup>6</sup> which states that "[t]he provisions of this Act . . . shall not apply to . . . gathering of natural gas." Only one year earlier, the Tenth Circuit had reversed the Commission on the gathering issue. It found that the Commission had improperly applied its "primary function" test and remanded for a determination of whether the pipeline's facilities are "gathering and exempt from Commission jurisdiction, or transportation and subject to jurisdiction."<sup>7</sup> A close reading of these two cases raised the question of whether the sections 4 and 5 theory relied upon by the Eighth Circuit.

The Eighth Circuit saw no possibility of conflict, noting that the Tenth Circuit "expressly declined to address the argument that sections 4 and 5 of the NGA grant FERC any authority over charges for gathering."<sup>8</sup> However, a number of the express findings made by the Tenth Circuit call into question

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1. 15 U.S.C. §§ 717(b)-717(d) (1988).

2. Pub. L. No. 101-60, 103 Stat. 157 (codified in scattered sections of 15 U.S.C. (Supp. I 1989)).

3. Northern Natural Gas Co. v. FERC, 929 F.2d 1261 (8th Cir. 1991).

4. 15 U.S.C. § 717(c), 717(d) (1988).

5. 929 F.2d at 1271.

6. 15 U.S.C. § 717(b) (1988).

7. Northwest Pipeline Corp. v. FERC, 905 F.2d 1403, 1412 (10th Cir. 1990).

8. 929 F.2d at 1273 (footnote omitted).

the Eighth Circuit's statement that "there is no conflict between that Court's opinion and the *theory* of our decision."<sup>9</sup>

For example, the Eighth Circuit's theory relies on sections 4 and 5 for jurisdiction over gathering while the Tenth Circuit looked to section 1(b) alone as the source of the Commission's jurisdiction and found that it is section 1(b) which "defines FERC's jurisdiction."<sup>10</sup> The Tenth Circuit found that Congress "confined FERC's jurisdiction *within the limits of section 1(b)* . . . ."<sup>11</sup> The Tenth Circuit stated: "If, upon proper application of the primary function test, the facilities are indeed exempt from Commission jurisdiction, whatever 'attractive gap' results was clearly created by Congress. Jurisdiction must already exist before the Commission can resort to analyzing its regulatory role by application of this theory."<sup>12</sup>

The Tenth Circuit also found that "'under section 1(b) the Commission does not have express or implied rate-regulatory jurisdiction of the production and gathering of gas.'"<sup>13</sup> In contrast, the Eighth Circuit adopted a theory requiring a "split" reading of the NGA, under which the Commission would have "rate-regulatory" jurisdiction over gathering under sections 4 and 5 but no certificate or abandonment jurisdiction over gathering facilities under section 7. The Eighth Circuit's "split" reading of the NGA to assert rate jurisdiction over gathering differs from the Tenth Circuit's reading under which gathering is excluded from *all* aspects of the Commission's jurisdiction, *including* "express or implied rate-regulatory jurisdiction."<sup>14</sup>

Under the Eighth Circuit's theory, the Commission's regulatory and rate jurisdiction does not extend to all gathering facilities, but rather, singles out the gathering facilities of one particular type of owner/operator—interstate pipelines. This selective jurisdiction theory stands in contrast to the finding of the Tenth Circuit that "[t]he gathering exemption was not meant to attach only to certain owners/operators but to facilities."<sup>15</sup> The Tenth Circuit emphasized that the mere fact that an interstate pipeline is the owner/operator of gathering facilities "cannot alone transform the character of these particular facilities" from nonjurisdictional to jurisdictional:

[D]espite any possible showing that the facilities might perform gathering, the Commission would deem them jurisdictional because of the perceived primary transportation function; i.e., ultimately, the facilities are owned by and eventually connected to a company which *has as its primary function* the interstate transportation of gas.

By taking Northwest's status into consideration as one factor, the Commission has, in fact, subsumed the primary function analysis within that factor. However, Northwest's status in interstate transportation cannot alone transform the character of these facilities.<sup>16</sup>

9. *Id.* at 1273 (emphasis added).

10. 905 F.2d 1403, 1406, (quoting *Panhandle Eastern Pipe Line Co. v. Public Serv. Comm'n*, 332 U.S. 507, 516 (1947)).

11. 905 F.2d 1403, 1407 (emphasis added).

12. *Id.* at 1412.

13. *Id.* at 1406 (citing *Colorado Interstate Gas Co. v. FPC*, 324 U.S. 581 (1945)).

14. *Id.* at 1406.

15. *Id.* at 1411.

16. *Id.* at 1410 (emphasis added).

The theory of the Eighth Circuit, however, allows the status of the owner/operator to “alone transform” nonjurisdictional gathering into a jurisdictional activity.

The Eighth Circuit also found that the question of gathering by interstate pipelines “involves interstate rates for which no local interest attaches and to which the states could not constitutionally or practicably exercise regulatory power.”<sup>17</sup> Significantly, the Tenth Circuit found no merit to the Commission’s argument that state regulation of gathering was not possible, stating that “in other cases, FERC has approved the indirect regulation of gathering facilities.”<sup>18</sup> It also noted that the Commission’s “assertion that Colorado and Utah have no interest or an adverse interest in this regulation is speculative.”<sup>19</sup>

The Eighth Circuit also based its decision in part on preserving the “pro-competitive goals” of the Natural Gas Policy Act (NGPA).<sup>20</sup> The Tenth Circuit, however, found that the NGPA made no change in section 1(b)’s exclusion of gathering from Commission jurisdiction.<sup>21</sup>

Finally, the reliance by the Eighth Circuit on the Commission’s policy arguments as to why it needs jurisdiction over gathering differs from the Tenth Circuit’s recognition that “the express jurisdictional limitation on FERC’s powers contained in section 1(b) of the NGA . . . cannot be recast or obscured in the agency’s attempt to formulate policy to protect the public interest and burner-tip consumer.”<sup>22</sup> The Tenth Circuit emphasized that “[u]nless Congress removes existing limitations on FERC’s jurisdiction, the Agency’s perception of national policy cannot establish or alter that jurisdiction which Congress has expressly granted.”<sup>23</sup>

On August 2, 1991, the Court of Appeals for the District of Columbia remanded for the second time in as many years the Commission’s assertion of jurisdiction over a 12.4 mile lateral pipeline connecting Williams Natural Gas Company’s (Williams) mainline system with an electric generating plant owned by PowerSmith Cogeneration Limited Partnership (PowerSmith), located in Oklahoma City.<sup>24</sup>

In 1989, Oklahoma Natural Gas Company (ONG), aggrieved by the loss

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17. Northern Natural Gas Co. v. FERC 929 F.2d 1261, 1274 (footnote omitted).

18. See, e.g., Galaxy Energies, Inc., 21 F.E.R.C. ¶ 61,208 (1982).

19. 905 F.2d at 1412.

20. 929 F.2d at 1270. Natural Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (1988).

21. 905 F.2d at 1407, n.9.

22. *Id.* at 1407 (footnote omitted).

23. *Id.* at 1407.

24. See, Oklahoma Natural Gas Co. v. FERC, 940 F.2d 699 (D.C. Cir. 1991) [hereinafter *ONG II*]. Williams’ lateral facilities are located entirely within the state of Oklahoma, and serve to transport to PowerSmith natural gas derived from production fields located in the western part of the state. Neither the Williams’ later facilities nor the natural gas transported through such facilities go beyond the Oklahoma state boundary. The transportation of natural gas to PowerSmith, however, was a part of the “backhaul” arrangement, pursuant to which PowerSmith contracted to purchase natural gas from Ladd Gas Marketing, Inc. (now Amax Gas Marketing, Inc.), a marketer located downstream from the PowerSmith plant. Under this arrangement, Williams would deliver gas through its lateral to the PowerSmith plant, and Ladd would compensate Williams by delivering gas to its pipeline at a number of designated receipt points downstream of the lateral, including locations in Kansas and Wyoming.

of a customer within its franchise area, appealed FERC's orders<sup>25</sup> authorizing construction of Williams' later facilities. ONG contended, among other things, that FERC lacked jurisdiction over the subject facilities. The Commission countered that the natural gas transactions involving Williams' later facilities constituted interstate transportation, subject to Commission NGA jurisdiction, because: (1) natural gas delivered to PowerSmith enters Williams' mainline system and commingles with other gas molecules, some of which are ultimately received by consumers in other states; and (2) the natural gas transactions utilizing Williams' later facilities constitute part of a "backhaul" arrangement, which, the Commission claimed, was tantamount to interstate transportation.

On September 19, 1990, the District of Columbia Circuit remanded for the first time FERC's assertion of jurisdiction over Williams' lateral facilities.<sup>26</sup> The court determined that the Commission failed to adequately explain the basis for its assertion of jurisdiction over Williams' later pipeline. On remand, the Commission attempted to explain its jurisdictional claim.<sup>27</sup> The court of appeals, however, remained unconvinced, noting that "the increased wording [of the FERC's explanation] does not help us very much to understand the Commission's position; it is as if on learning that a listener does not understand English, the speaker tries shouting."<sup>28</sup>

The court rejected the Commission's argument that it has jurisdiction over Williams' later facilities because gas molecules being transported through the facilities commingled with other gas molecules, some of which eventually flowed in interstate commerce. The court distinguished precedents<sup>29</sup> relied upon by the Commission, which were premised on the notion that natural gas "was dedicated to interstate commerce whenever it was commingled in any fashion with jurisdictional gas."<sup>30</sup> This premise, the court held, was "undermined by changes in the natural gas industry caused by the massive deregulation of gas transportation pursuant to the Natural Gas Policy Act of 1978 and the Commission's promulgation of Orders Nos. 436 and 500."<sup>31</sup> The Court also questioned the FERC's argument that the "backhaul" arrangement involving Williams, PowerSmith, and Ladd somehow transformed the delivery of natural gas from western Oklahoma to PowerSmith into interstate transportation. The court rejected the Commission's theory that the underlying economic facts of the transaction should determine its jurisdiction, and

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25. Williams Natural Gas Co., 46 F.E.R.C. ¶ 61,160, *reh'g denied*, 47 F.E.R.C. ¶ 61,308 (1989).

26. Oklahoma Natural Gas Co. v. FERC, 906 F.2d 708 (D.C. Cir. 1990).

27. Williams Natural Gas Co., 52 F.E.R.C. ¶ 61,294 (1990).

28. *ONG II*, *supra* note 24 at 700.

29. California v. Lo-Vaca Gathering Co., 379 U.S. 366 (1965) (affirming FERC jurisdiction over gas intended for end use that was commingled with gas that was sold for resale) and Louisiana Power and Light Co. v. FPC, 483 F.2d 623, *cert. denied* 416 U.S. 974 (1973) (FERC had jurisdiction where a gas company injected some of its gas from the interstate system into an intrastate system).

30. *ONG II*, *supra* note 24 at 703.

31. *Id.* at 703 (internal quotes omitted). The court noted that FERC likewise had rejected the theory that commingled gas is necessarily "dedicated to interstate commerce" in Mississippi Valley Gas Co. v. Gulf Fuels Inc., 48 F.E.R.C. ¶ 61,178 at 61,656 & n.16 (1989) ("[i]n recent years, with the deregulation of producer sales, the concept of "dedication to interstate commerce" has largely lost its significance").

that "the *economic effect* of the [Williams, PowerSmith, and Ladd] transaction is that a specific amount of gas enters Williams' system in Kansas and Wyoming and that the same amount of gas leaves Williams' system in Oklahoma."<sup>32</sup> If the FERC's legal theory were carried to its logical conclusion, the court inquired, would not the Commission be able to extend its jurisdiction "in almost any situation, thereby rendering the 'sale for resale' jurisdiction limitation nugatory?"<sup>33</sup> The court concluded that the Commission must provide us with more to gain acceptance of its definition of interstate transportation.

On September 26, 1991, in response to the court's second remand, the Commission requested interested parties to file briefs and reply briefs addressing, among other things, legal theories and case citations supporting or refuting the notion that backhaul arrangements were intended to be excluded from the FERC jurisdiction. The remand proceeding has not yet concluded.

### III. WELLHEAD SALES ISSUES

#### A. Old Gas Pricing

A number of court decisions issued in 1991 resolved long-standing controversies over the pricing of first sales of natural gas. In *Mobil Oil Exploration and Producing Southeast Inc. v. United Distribution Cos.*,<sup>34</sup> the U.S. Supreme Court affirmed the Commission's Order No. 451,<sup>35</sup> issued in 1986. The Court's unanimous decision reversed an earlier conclusion reached by a divided panel of the Fifth Circuit in 1989, which had rejected Order No. 451 in its entirety.<sup>36</sup> The Supreme Court's opinion appears to resolve a question over the Commission's authority to adapt its policies under the NGA and the NGPA to address the dramatic changes that have taken place in the gas industry over the past decade.

The Commission's Orders Nos. 451 and 451-A, both issued in 1986, established a single alternative maximum lawful price for "old" natural gas under NGPA sections 104 and 106.<sup>37</sup> "Old" gas had been "vintaged" under a series of area and national rate proceedings issued by the Federal Power Commission in the 1960s and 1970s, pursuant to the Commission's rate authority under section 4 and 5, and the *Phillips Petroleum Co. v. Wisconsin* decision.<sup>38</sup> Sections 104 and 106 provided, *inter alia*, that the Commission "may, by rule or order, prescribe a maximum lawful ceiling price, applicable to any first sale of natural gas (or category thereof, as determined by the Commission) otherwise subject to the preceding provisions of this section." Any such ceiling must be (1) higher than the present ceiling, and (2) "just and reasonable"

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32. *ONG II*, *supra* note 24, at 701.

33. *Id.* at 702.

34. 111 S. Ct. 615 (1991).

35. Order No. 451, *Ceiling Prices, Old Gas Pricing Structure* [1986-1990 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,701 (1986); Order No. 451-A, [1986-1990 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,720 (1986).

36. *Mobil Oil Exploration & Producing Southeast, Inc. v. FERC*, 885 F.2d 209 (5th Cir. 1989).

37. 15 U.S.C. §§ 3314, 3316 (1988).

38. 347 U.S. 672 (1954).

within the meaning of the NGA.<sup>39</sup>

In Order No. 451, the Commission set the alternative ceiling at the highest "vintage" level for old gas: the post-1974 flowing gas rate. The final rule established an elaborate and complex "Good Faith Negotiation" (GFN) procedure for producers and purchasers who could not agree over whether to escalate the price of old gas to the alternative ceiling. The GFN procedure permitted abandonment of the sale or purchase obligation under NGA section 7(b),<sup>40</sup> upon full compliance with the procedure, if the parties could not agree on an alternative price.

With respect to pricing issues, the Court rejected arguments that the "regulatory structure" of the NGPA was intended to preserve the benefits of the vintage structure of old gas for consumers.<sup>41</sup> The Court analyzed the application of the "just and reasonable" concept as applied in the Federal Power Commission (FPC) area and national rate opinions, finding that the employment of a "replacement cost formula" was consistent with the FPC's prior practice.<sup>42</sup> The Court rejected contentions that the Commission's establishment of the GFN procedure as a precondition to collection of the alternative maximum lawful price was an acknowledgement that the ceiling was too high. Even though the Court recognized that the ceiling was above marked levels, it found that the ceiling was justified by the need to mitigate against "too abrupt a transition from one pricing regime to the next."<sup>43</sup> The Court found further that a supra-market price ceiling did not constitute *de facto* deregulation.

With respect to abandonment issues, the Court affirmed the Commission's authority to pre-grant abandonment of certificated producer sales under section 7(b) of the NGA<sup>44</sup> by generic rule, upon satisfaction of the GFN procedure. The Court read three requirements into section 7(b), and found that Order No. 451 complied with all three. First, the Commission had to permit the abandonment. The Court held that the Commission had authority to grant a "prospective," "conditional" abandonment under this authority.<sup>45</sup>

Second, the Commission had to make the "public convenience and necessity" finding.<sup>46</sup> The Commission satisfied this requirement by finding that the Order No. 451 procedures protected purchasers by permitting them to buy gas elsewhere, at market rates, if contracting producers insisted on the supra-market alternative maximum lawful price. The Court also found a general market benefit resulting from the release of previously unused reserves of old gas.

The third requirement of section 7(b) is that the Commission hold a "due hearing."<sup>47</sup> The Court found the hearing requirement satisfied by virtue of the

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39. 15 U.S.C. §§ 3314, 3316 (1988).

40. 15 U.S.C. § 717f(b) (1988).

41. *Mobil Oil Exploration & Producing Southeast, Inc. v. United Distribution Cos.*, 111 S. Ct. 615, 623 (1991).

42. *Id.* at 624.

43. *Id.* at 625.

44. 15 U.S.C. § 717f(b) (1988).

45. *Mobil Oil*, 111 S. Ct. at 626.

46. *Id.* at 626.

47. *Id.* at 626.

Administrative Procedure Act notice-and-comment on the rule.

*B. Contracts*

In *South Dakota Public Utilities Commission v. FERC*,<sup>48</sup> the District of Columbia Circuit may have closed the book on the last of the Order No. 23 third party-protest proceedings.<sup>49</sup> At issue was whether the area rate clauses contained in approximately 1,200 contracts between Northern Natural Gas Company and hundreds of producer-suppliers of Northern authorized collection of NGPA ceiling prices. Following a lengthy hearing, the Administrative Law Judge held that all of the area rate clauses at issue authorized collection of the ceiling prices. The Commission affirmed the Judge. The court of appeals affirmed the Commission.

The opinion is perhaps most interesting for its discussion on contract interpretation. The court's discussion of the long-standing Commission interpretation of a standard and widely-used contract provision may offer parties to contract disputes further guidance on how to structure their cases for appellate review.

For the most part, the opinion is a straightforward review under the substantial evidence standard. Indeed, the court affirms the Commission based on its finding that substantial evidence supported the Commission's orders.<sup>50</sup> However, the opinion contains a discussion of contractual intent that criticizes the Commission's formulation of the issue as having not "quite confront[ed] the reality of the case." The Commission determined that the parties had intended to pay "the highest prices allowed by law or regulation." The court suggests that this general intent "is hardly historical reality." Citing several treatises on contracts, the opinion concludes that a "blunter way of framing the issue would be to ask whether the parties would have intended area rate clauses to authorize payment of NGPA rates if they had anticipated them at the time they negotiated the clauses."<sup>51</sup> Elaborating, the court stated that the "problem is . . . how to fill a contract gap—how to address a circumstance that the contract plainly omitted . . ."<sup>52</sup>

In a constantly changing regulatory environment in which contracts may be rendered ambiguous by new rules or statutes, parties should be cognizant of the District of Columbia Circuit's views regarding deference to the Commission's analysis of what might be considered purely legal questions, as well as the court's own substantive analysis of contractual intent. In *South Dakota*, the outcome was the same under both analyses; the record contained ample supporting evidence on which to affirm the Commission, and no showing was

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48. 934 F.2d 346 (D.C. Cir. 1991).

49. As of this writing, a petition for certiorari to the U.S. Supreme Court was pending. *South Dakota Pub. Utils. Comm'n v. FERC*, No. 91-798. (It has since been denied and may be found at 60 U.S.L.W. 3581 (1992)). The majority of the other third-party protest cases were resolved years earlier. *Associated Gas Distribs. v. FERC*, 810 F.2d 226 (D.C. Cir. 1987); *Pennzoil Co. v. FERC*, 789 F.2d 1128 (5th Cir. 1986); *Hunt Oil Co. v. FERC*, 853 F.2d 1226 (5th Cir. 1988).

50. 934 F.2d at 353.

51. *Id.* at 350.

52. *Id.* at 352.

made that the protesting parties could have structured the case to achieve a different result. However, other cases may not be so straightforward, and parties seeking simultaneously to satisfy both the Commission's and the court's contractual doctrines may face a serious dilemma.

### C. Deregulation

In two separate opinions, the District of Columbia Circuit affirmed Commission rules against challenges that the rules improperly exceeded the Commission's authority under the Wellhead Decontrol Act of 1989.<sup>53</sup> The Act repeals all remaining price controls imposed by the NGPA on "first sales," effective January 1, 1993. In addition, the Act contains certain interim repeal provisions.

In *Union Pacific Resources Co. v. FERC*,<sup>54</sup> the court of appeals reviewed the Commission's Order No. 523,<sup>55</sup> which implemented the Act. Although Order No. 523 was largely noncontroversial, the rule provided for decontrol of first sales of gas that was released *temporarily* from pre-enactment contracts. A number of gas producers challenged this provision in the rule, because such a price deregulation eliminated their entitlement to nonconventional fuels tax credits for "tight formation" gas under section 29 of the Internal Revenue Code,<sup>56</sup> which then required, *inter alia*, that all gas eligible for the credit must be subject to price controls.

Thus, the producers who challenged the rule were placed in the somewhat awkward and ironic position of arguing in favor of continuing applicability of federal price ceilings on wellhead sales, due to commercial reliance on the perverse incentives created by the statutory regime of the NGPA and the Commission's orders implementing the statute. It appears that this irony was not entirely lost on the court of appeals.<sup>57</sup> Indeed, the court expressed some annoyance with the producers for leaving the court "in the dark as to how much otherwise price-controlled 'tight formation gas' is actually at stake here."<sup>58</sup>

The District of Columbia Circuit's affirmance follows a fairly standard

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53. Pub. L. No. 101-60, 103 Stat. 157 (codified in scattered sections of 15 U.S.C.).

54. 936 F.2d 1310 (D.C. Cir. 1991).

55. Order No. 523, *Order Implementing the Natural Gas Wellhead Decontrol Act of 1989*, [1986-1990 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,887 (1990).

56. 26 U.S.C. § 29 (1988).

57. 936 F.2d at 1312 n.2 (citing *FERC v. Martin Exploration Management Co.*, 486 U.S. 204 (1988), in which the Court rejected arguments by producers that gas which qualified under both regulated and deregulated NGPA categories should continue to be subject to price ceilings, which at the time were higher than market prices).

In fact, the Court describes the general "area rate clause" indefinite price escalator provisions at issue in *South Dakota Pub. Utils. Comm'n.*, described above, suggesting that price ceilings such as the tight formation price ceiling "may give a producer a contract right to a higher price than it could otherwise secure under its sales contract." 936 F.2d 1312 n.2. Ironically, as discussed more fully below, the Commission's regulations did not permit collection of tight formation prices under area rate clauses. Indeed, and as stressed by the same court in another recent case, producers of tight formation gas were required to obtain specific and express agreement from their purchasers that the tight formation incentives price or some other fixed incentive price would be paid. See 18 C.F.R. §§ 271.701, *et seq.*

58. 936 F.2d at 1313 n.4.



approach under *Chevron U.S.A., Inc. v. NRDC*,<sup>59</sup> to review of agency action implementing a recently-enacted statute governing the subject area of that agency's expertise. The court accepted the Commission's holding as supported by the plain language of the statute and the general Congressional intent. The court acknowledged that one passage in the legislative history suggested that the Congress did not intend to decontrol temporarily released gas that remained subject to "an underlying contractual obligation to deliver gas when the release period ends."<sup>60</sup>

One might reasonably wonder how the court would have regarded this passage if the petitions for review had been filed by customers of a pipeline seeking to enforce a pipeline's "underlying" contractual right to released gas. The court understandably was "less than thoroughly convinced" by the Commission's explanation of the contextual meaning of the passage. In any event, the court found that in context, the passage could not support the petitioner's assertion that Congress effectively commanded the retention of tax incentive eligibility.<sup>61</sup>

In a related case, *Williams Natural Gas Co. v. FERC (Williams II)*,<sup>62</sup> a divided panel of the District of Columbia Circuit affirmed the Commission's decision to prospectively terminate the tight formation incentive price effective May 15, 1990, for wells drilled on or after that date. This case followed an earlier remand from the court<sup>63</sup> (*Williams I*). In *Williams I*, the court remanded Commission orders that terminated a rulemaking proceeding in which the Commission proposed to place a limit on the incentive ceiling price for tight formation gas.<sup>64</sup> The *Williams I* court found that the Commission's explanation of its decision to terminate the rulemaking proceeding was inadequate.

On remand, the Commission issued Order No. 519,<sup>65</sup> which eliminated the ceiling price for gas produced from wells drilled after May 12, 1990. Two parties sought review, attacking from opposite ends of the spectrum. Williams Natural Gas Company (Williams) sought judicial review, contending that the Commission was required to eliminate the incentive ceiling as of February 22, 1983, the date of issuance of the original notice of proposed rulemaking (NOPR).<sup>66</sup> ARCO Oil and Gas Company (ARCO), the other petitioner, contended that the elimination of the price ceiling on a basis more accelerated than the elimination of price controls under the 1989 Wellhead Decontrol Act was inconsistent with that Act, as well as with the Internal Revenue Code.

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59. 467 U.S. 837 (1984).

60. S. Rep. No. 39, 101st Cong., 1st Sess. at 13 (1990).

61. 936 F.2d at 1313.

62. 943 F.2d 1320 (D.C. Cir. 1991) (*Williams II*).

63. *Williams Natural Gas Co. v. FERC*, 872 F.2d 438 (D.C. Cir. 1989) (*Williams I*).

64. The tight formation price, established pursuant to the Commission's authority under sections 107(b) and 107(c)(5) of the NGPA, 15 U.S.C. §§ 3317(b) and 3317(c)(5), was equal to 200% of the ceiling price for gas produced from new, onshore production wells under NGPA section 103, 15 U.S.C. § 3313.

65. Order No. 519, *Limitation on Incentive Prices for High-Cost Gas to Commodity Values*, [1986-1990 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,879 (1990).

66. Notice of Proposed Rulemaking, *Limitation on Incentive Prices for High Cost Gas to Commodity Values*, [1982-1987 Proposed Regs.] F.E.R.C. Stats. & Regs. ¶ 32,294, 48 Fed. Reg. 7,469 (1983).

The majority rejected both sets of contentions. The panel held unanimously that neither the Wellhead Decontrol Act nor the Internal Revenue Code required the Commission to maintain the incentive ceiling price levels until statutory decontrol. Under the Decontrol Act, the Commission retained the authority to reexamine the reasonableness and necessity of the incentive ceilings it established pursuant to its discretionary authority under NGPA section 107(b). The court noted further that Congress could have amended the tax code to completely reinstate the lost tax credit when it amended the code in November 1990, to extend the credit, but did not do so. With regard to Williams' contention that the Commission was required to eliminate the price effective with the issuance of the 1983 NOPR, the court affirmed the FERC's conclusion that producers' reliance on a stable pricing scheme was supportable. In particular, the court noted with approval the Commission's explicit re-examination and disavowal of the tentative conclusion reached in the 1983 NOPR that the incentive price was not reasonable or necessary. The court also emphasized the reliance of the Commission on the "negotiated contract price" requirement in Order No. 99,<sup>67</sup> the original tight formation rule. That requirement compelled producers and pipelines to amend the price provisions in their sales contracts to explicitly provide for section 107 tight formation ceiling prices (or fixed prices at or below those ceilings).

One of the key issues raised by *Williams I* was the Commission's power to engage in what could be characterized as retroactive rulemaking. This issue has come before the District of Columbia Circuit in several recent cases not involving gas regulation.<sup>68</sup> In *Williams II*, the FERC and supporting intervenors argued in essence that a revocation of the incentive price amount to a retroactive rule. Resolution of the FERC's authority to make or revoke rules retroactively, however, will have to await another case, because the court of appeals did not reach the issue.

Judge Edwards contended in his dissent that the Commission's orders did not offer a reasoned explanation for the Commission's decision not to reduce the incentive price for all tight formation wells spudded, recompleted or reworked after the NOPR's publication.<sup>69</sup> The dissent stated that the FERC realized the need to reexamine the tight formation price "[w]hen the bottom dropped out of the oil market two years later."<sup>70</sup> According to the dissent, the FERC "essentially sidesteps" the issue of whether the incentive ceiling is "reasonably necessary," relying on general industry trends, rather than examining whether a supra-market price can be "reasonable" and "necessary," as required by section 107(b).<sup>71</sup>

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67. Order No. 99, *Regulations Covering High-Cost Natural Gas Producing from Tight Formations*, [1977-1981 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,183 (1980).

68. *Bowen v. Georgetown Univ. Hospital*, 488 U.S. 204 (1988); *Beverly Hospital v. Bowen*, 872 F.2d 483 (D.C. Cir. 1989).

69. *Williams II*, 943 F.2d 1320, 1339 (D.C. Circuit 1991).

70. *Williams II*, *Id.* 1340.

71. *Williams II*, *Id.* 1341.

## IV. QUALIFYING FACILITIES

On August 2, 1991, the District of Columbia Circuit remanded two issues concerning the Commission's approval, subject to several terms and conditions, of the proposed merger of Utah Power & Light Company (UP&L), PacifiCorp (PacifiCorp Maine) and PC/UP&L Merging Corporation (PacifiCorp Oregon) into a combined entity that was subsequently renamed PacifiCorp.<sup>72</sup> Practitioners who focus exclusively in the natural gas regulatory area will find striking similarities between the issues addressed in this case and competitive issues in the gas industry.

At issue was whether the Public Utilities Regulatory Policies Act of 1978 (PURPA)<sup>73</sup> and the Federal Power Act (FPA)<sup>74</sup> mandated transmission access to qualifying facilities (QFs) in merger cases. In the orders on review, the Commission required only *voluntary* QF access, conditioned on QFs' waiver of their PURPA mandatory purchase rights.<sup>75</sup> The orders conditioned approval of the merger on the provision of firm wholesale transmission service at cost-based rates to any "utility" that requests such service, and excluded QFs from the definition of "utility."

In support of its orders, the Commission relied upon several rationales. First, the Commission reasoned that since any distant utility interconnected with PacifiCorp that wished to purchase the QFs' power could obtain transmission from the merged company under the wheeling conditions, the exclusion of QFs from the wheeling conditions would only mean that the distant utility, which voluntarily sought to purchase the QFs' output, rather than the QFs themselves, would have to arrange transmission from the merged company. In other words, the QFs could complete sales to a distant utility, but they would have to obtain transmission from the purchasing utility.

Second, the Commission was concerned that allowing QFs' to participate directly in the merger wheeling conditions "would be a major extension of their rights under the PURPA scheme . . . justified neither on the record of this case nor by section 210 of PURPA itself."<sup>76</sup> In other words, QFs could impose upon distant utilities the obligation to purchase the QF's power. Third, the record did not indicate that a QF access condition was necessary to mitigate the merged company's enhanced market power resulting from the merger.

Fourth, the Commission expressed concern that providing QFs with access under the merger wheeling conditions would have the potential, especially in the long term, for distorting markets for generation services at any time the avoided costs in those markets diverged significantly from market or negotiated prices. Fifth, the Commission did not wish to create an undue

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72. *Environmental Action, Inc. v. FERC*, 939 F.2d 1057 (D.C. Cir. 1991). The Commission issued an order on remand, *Utah Power & Light Co.*, 57 F.E.R.C. ¶ 61,363 (1991).

73. Pub. L. No. 95-617, 92 Stat. 3117 (codified in scattered sections of titles 15, 16, 30, 42 & 43 of U.S.C.).

74. Pub. L. No. 95-617, 92 Stat. 3148 (codified in scattered sections of titles 15, 16, 30, 42 & 43 of U.S.C.).

75. *Utah Power & Light Co.*, 45 F.E.R.C. ¶ 61,095 (1988), *on reh'g*, 47 F.E.R.C. ¶ 61,209 (1989).

76. 47 F.E.R.C. ¶ 61,209 at 61,470.

preference for QFs. (The Commission did not press the fourth and fifth rationales on review.)

The Commission also denied the requests of industrial end-users to expand the applicability of the transmission conditions to end-users, stating that such bypasses could jeopardize the recovery of the investment the merged company made to serve those customers. The end-user discussion was confined to a footnote in the rehearing order.

On review, the court remanded to the Commission for further consideration of the QF exclusion and end-user exclusions. The court based its determination on an "arbitrary and capricious" analysis of the QF exclusion issue, concentrating primarily on the underlying purposes of the statutes at issue. Using a consumer viewpoint analysis consistent with the antitrust laws, the court noted that the antitrust laws are intended to promote competition to benefit consumers, not simply to enhance competition for competition's sake.

Moreover, reasoned the court, "such advantage as a QF may have stems directly from the Congress's policy choice to encourage the sale of power by QFs rather than by traditional utilities."<sup>77</sup> The court added that although the operation of PURPA may not be "wholly consistent" with the antitrust laws, PURPA deserved at least as much weight as the antitrust laws.

Finally, the court analyzed the Commission's decision from the perspective of the QFs rather than the potential customers, and still found the decision wanting. By precluding the QFs from access, PacifiCorp "can buy the QF's power and then sell its own power to a distant purchaser with a higher decremental cost." Thus, PacifiCorp can capture for itself the difference between the price paid to the QF and the distant market resale price.<sup>78</sup>

The court next turned to the Commission's exclusion of end-users. It reviewed this holding under more of a substantial evidence standard than the arbitrary and capricious standard applied to the QF exclusion. The court found no evidence or analysis, "substantial or otherwise," to support a finding that PacifiCorp would be unable to earn an appropriate return on its investment due to the threat of bypass. The court contrasted the Commission's end-user exclusion in this case with natural gas bypass cases, where the Commission has permitted interstate pipelines to connect directly with end-users, bypassing local distribution company services.<sup>79</sup> Finally, the court rejected claims that the FERC (1) improperly failed to require a PacifiCorp to wheel non-firm power and (2) established excessive non-firm transmission rates, deferring to the FERC's expertise to make predictive assessments about the market impact of the merger.

## V. CASES INVOLVING THE NOTICE AND COMMENT REQUIREMENTS

In *Public Service Commission of Wisconsin v. FERC*,<sup>80</sup> which is a pending decision, the petitioner raised the issue of whether the FERC's Rate Design

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77. *Environmental Action, Inc. v. FERC*, 939 F.2d 1057, 1062 (D.C. Cir. 1991).

78. *Id.* at 1062.

79. *Id.* at 1063.

80. No. 89-1598 (D.C. Cir. Sept. 25, 1991).

Policy Statement (Policy Statement),<sup>81</sup> although labeled a policy statement, actually established substantive rules adopted without the notice and opportunity for comment required by the Administrative Procedures Act (APA).<sup>82</sup>

The "policy statement" issue is also presently before the District of Columbia Circuit on review of Order Nos. 528,<sup>83</sup> *Tennessee Gas Pipeline Co. v. FERC*. The court has called for separate briefing on a Commission motion for dismissal. Given the emerging importance of the issues of the requirement for and the adequacy of notice and comment opportunities, this section will briefly review the issues raised by the Rate Design Policy Statement case.

In defending its actions, the FERC brief asserted that the Commission's orders articulated a general statement of policy, not a binding rule; therefore, in accordance with an exemption provided in the APA, the FERC properly issued the Policy Statement without notice and comment. Intervenor's brief in support of the FERC position, asserted that the Commission's issuance of a policy statement did not constitute the establishment of a rule, and therefore did not require prior notice and comment under the APA. It also asserted that the Public Service Commission of Wisconsin (PSCW) failed to show any concrete case, controversy, or grievance flowing from the issuance of the Policy Statement; and, further that the court should view the Policy Statement in the context, of transition to a procompetitive model.

#### A. *The FERC Position*

In its brief, the Commission explained that under the APA, when the Commission issues "a general statement of policy," it is exempt from the formal notice and comment procedure requirements.<sup>84</sup> The Commission cited *Pacific Gas & Electric Co. v. FPC (PG&E)*, wherein the D.C. Circuit explained that:

A general statement of policy is the outcome of neither a rulemaking nor an adjudication; it is neither a rule nor a precedent but is merely an announcement to the public of a policy which the agency hopes to implement in future rulemakings or adjudications. A general statement of policy, like a press release, presages an upcoming rulemaking or announces the course which the agency intends to follow in future adjudications.<sup>85</sup>

In *PG&E* the court found that the FPC order was a policy statement, as opposed to a binding rule because: (1) the order did not establish a curtailment plan for a particular pipeline, (2) the effect of the order was to inform the public of the types of plans which would receive tentative approval, without giving assurance of final approval, and (3) the order "was not finally determinative of the rights and duties of a given pipeline" and envisioned further proceedings.

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81. *Interstate Natural Gas Pipeline Rate Design, Policy Statement Providing Guidance With Respect to the Designing of Rates*, 47 F.E.R.C. ¶ 61,295, *reh'g denied*, 48 F.E.R.C. ¶ 61,122 (1989).

82. 5 U.S.C. § 553 (1988).

83. Order No. 528, *Order on Remand Staying Collection of Take or Pay Fixed Charges and Directing Filing of Revised Tariff Provisions*, 53 F.E.R.C. ¶ 61,163 (1990).

84. FERC Initial Brief at 13, *citing* 5 U.S.C. § 553(b)(3)(A) (1988).

85. 506 F.2d 33, 38 (D.C. Cir. 1974) (*PG&E*).

In defense of the Policy Statement, the Commission asserted that its order articulates a general statement of policy, not a binding rule. It is in accord with the *PG&E* decision, because the Policy Statement: (1) does not impose a specific rate design on any particular pipeline, (2) gives notice of the types of rate designs that the Commission requires pipelines to consider, not automatically implement, and (3) expressly envisioned further proceedings wherein the ALJs and the participants would be guided by the Policy Statement in resolving rate design issues.

The Commission stressed that the Policy Statement was not determinative of the rights and duties of any specific pipeline because it specified that the Commission would examine the rate design principles "on a case-by-case basis," and that it did "not intend to transform any of the rate proceedings into generic industry-wide forums for policy development."<sup>86</sup> Thus, the Commission contended that the Policy Statement is not a binding rule, and falls within the exception to the notice and comment requirements.

The Commission argued that its position is supported by the court's recent decisions in *Air Transport Ass'n. of America v. Department of Transportation (ATA)*<sup>87</sup> and *Public Citizen Inc. v. United States Nuclear Regulatory Commission (Public Citizen)*.<sup>88</sup> In *ATA*, the court found that the Federal Aviation Administration was required to engage in notice and comment procedures when implementing rules imposing civil penalties. The court held that when "nominally 'procedural' rules 'encode a substantive value judgment' or 'substantially alter the rights or interests of regulated' parties, . . . the rules must be preceded by notice and comment." The court also held that the rules were not merely procedural because they "substantially affect[ed] . . . defendants' rights to adjudication," and embodied "discretionary—indeed, in many cases, highly contentious—choices concerning what process civil penalty defendants are due." In *Public Citizen*, the court dismissed a challenge to a Nuclear Regulatory Commission (NRC) policy statement, finding that because the policy statement sent mixed messages, and because the NRC had not yet applied the policy statement to concrete situations, it was impossible to determine whether the policy statement was a binding or non-binding order.

In reliance on these decisions, the Commission argued that the Policy Statement did not "substantially alter the rights or interests of the regulated entities" within the meaning of *ATA*. The Policy Statement merely required parties to rate proceedings to develop a record on particular issues. Further, the FERC Policy Statement can be distinguished from the policy statement under consideration in *Public Citizen* because it states explicitly that it has no binding effect and in several FERC proceedings has been applied in this fashion.

### B. *The Wisconsin Position*

The PSCW argued on brief that exceptions to the APA's general rule

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86. FERC Initial Brief at 15, *citing*, 47 F.E.R.C. ¶ 61,295 at 62,059 (1989).

87. 900 F.2d 369 (D.C. Cir. 1990).

88. 940 F.2d 679 (D.C. Cir. 1991).

requiring notice and comment should be construed very narrowly in order to prevent the circumvention of the opportunity for public participation in regulation. In support of its position, PSCW quoted the decision in *American Hospital Ass'n v. Bowen*,<sup>89</sup> wherein the court discussed Congress' intent that the exceptions to the notice and comment requirements of section 553 of the APA should be narrowly construed:

The reading of the § 553 exemptions that seem most consonant with Congress' purposes in adopting the APA is to construe them as an attempt to preserve agency flexibility in dealing with limited situations where substantive rights are not at stake. The exceptions have a common theme in that they "accommodate situations where the policies promoted by public participation in rulemaking are outweighed by the countervailing considerations of effectiveness, efficiency, expedition and reduction in expense."<sup>90</sup>

PSCW asserted that the two compelling reasons for limiting the exceptions to section 553 are: (1) the need to ensure maximum participation in regulatory matters in order that "the regulators are regulated"; and (2) to promote informed decisionmaking by the agency.<sup>91</sup>

In framing its argument that the Policy Statement has a present-day binding effect and thus constitutes a substantive rule which requires notice and comment, the PSCW cited *Community Nutrition Institute v. Young (CNI)*.<sup>92</sup> In *CNI*, the court set forth two criteria that distinguish a policy statement from a rule. First, mere pronouncements of what the agency intends—whether for the present or for the future—which do not have binding effect, are properly classified as interpretive rules. Second, the court indicated that it is significant to determine whether the specific language in the pronouncement genuinely leaves the agency and its decisionmakers free to exercise discretion.

The *CNI* case considered whether the establishment of certain allowable levels of food contaminants constituted a rulemaking. It found that what the agency labeled as a policy statement, in actuality, was a rule. In making this finding, the court focused on three factors: (1) the language of the pronouncement had a binding effect, (2) the pronouncement required parties to obtain exemptions from the established contaminant levels where necessary, and (3) subsequent pronouncements by the agency indicated that a binding norm had been established.

The PSCW asserted that five specific components of the FERC's Policy Statement are of a mandatory and definitive nature. First, the Commission extended the requirements of open-access transportation services to other transportation and bundled sales services.<sup>93</sup> Second, the Commission estab-

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89. 834 F.2d 1037 (D.C. Cir. 1987).

90. *Id.* at 1045. Also citing *Alcaraz v. Block*, 746 F.2d 593, 612 (9th Cir. 1984), *American Bus Ass'n v. U.S.*, 627 F.2d 525, 528 (D.C. Cir. 1980).

91. Intervenor Brief at 8, citing *American Bus*, *supra* note 90, and *Guardian Fed. Sav. & Loan Ass'n v. Federal Sav. & Loan Ins. Corp.*, 589 F.2d 658, 662 (D.C. Cir. 1978).

92. 818 F.2d 943 (D.C. Cir. 1987).

93. Intervenor Brief at 12, citing *Interstate Natural Gas Pipeline Rate Design*, 48 F.E.R.C. ¶ 61,122, at 61,444 (1989).

lished a seasonal rate policy which shifted costs to peak-day customers.<sup>94</sup> Third, the Commission required that contract demand adjustments accompany seasonal rates and a one-part demand charge.<sup>95</sup> Fourth, the Commission required nondiscriminatory backhaul rates and exchange transactions.<sup>96</sup> Fifth, the Commission revised its policy on the discounting of transportation rates.<sup>97</sup>

Moreover, PSCW contended that the Policy Statement is a substantive rule under the APA because it limits the exercise of discretion by Commission decisionmakers regarding important aspects of natural gas ratemaking.<sup>98</sup> On this point, the PSCW noted that the Policy Statement directs the ALJ and participants to not only consider the issues contained therein, but to resolve them in a manner "consistent with the directions of this policy statement."<sup>99</sup> Further evidence supporting the view that the Policy Statement constitutes a substantive rule, according to PSCW, is that the Commission has applied it as a binding rule in subsequent cases.<sup>100</sup> Finally, PSCW argues that a review of numerous Commission decisions since the Policy Statement was issued indicates that in proceedings where a settlement complied with the Policy Statement, the Commission has approved it. Where the settlement did not comply, the Commission rejected it, even if the settlement was uncontested.

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Patricia E. Schmid

Jean E. Sonneman

Steve Stojic

94. Intervenor Brief at 13, *citing* Natural Gas Pipeline Co. of America 47 F.E.R.C. ¶ 61,295, at 62,054 (1989).

95. Intervenor Brief at 14, *citing* 47 F.E.R.C. ¶ 61,295, at 62,055 (1989).

96. Intervenor Brief at 14-15, *citing* 47 F.E.R.C. ¶ 61,295, at 62,059 (1989).

97. Intervenor Brief at 15-16, *citing* 47 F.E.R.C. ¶ 61,295, at 62,056-57 (1989) and 48 F.E.R.C. ¶ 61,122, at 61,448-49 (1989).

98. Intervenor Brief at 17-19.

99. *Id.*, *citing* 47 F.E.R.C. 61,295, at 62,054 (1989).

100. Intervenor Brief at 19-25.