NOTE

CONOCO v. FERC: GATHERING AND FERC'S JURISDICTION

I. INTRODUCTION

Interstate gas pipeline companies, regulated by the Federal Energy Regulatory Commission pursuant to the Natural Gas Act,[1] are responding to changes in the regulatory scheme by modifying their corporate structures. These companies were once gas merchants, selling gas to local distribution companies (LDC) at prices that included charges for the associated services of gathering[2] and interstate transportation.[3] Over the past fifteen years, orders by the Federal Energy Regulatory Commission (FERC) designed to increase competition[4] have led to a restructuring of the natural gas industry so that interstate pipeline companies are now predominantly in the business of gas transportation rather than gas sales.[5]

In addition to requiring the unbundling of gas sales from transportation, Order No. 636 also required that the pipelines file separate rates for the transportation functions of gathering and interstate transportation.[6] Once they were required to publish separate rates, these companies saw an opportunity to remove part of their operations from federal jurisdiction.[7]

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1. Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w (1994).

2. Gathering is one of a number of services associated with the delivery of natural gas. The gas produced by a number of wells is gathered, generally to a single point, by a series of relatively short, relatively small-diameter pipelines to get it ready for entry into a high pressure transport pipeline. Conoco Inc. v. FERC, 90 F.3d 536, 543-544 (D.C. Cir. 1996), *cert. denied*, Amoco Energy Trading Corp. v. FERC, 117 S. Ct. 1017 (1997). It then travels through the transport pipeline, generally to a Local Distribution Company (LDC), and finally through the LDC's delivery system for supplying the consumer. Gas may also be stored for some time before it is delivered.

3. Adam D. Samuels, *Reliability of Natural Gas Service for Captive End-Users Under the Federal Energy Regulatory Commission's Order No. 636*, 62 GEO. WASH. L. REV. 718, 721-722 (1994). The LDCs had no choice but to buy the gas and the services as one package. *Id.*

4. These orders culminated in Order No. 636, which mandated open access and the unbundling of gas sales and transportation. Order No. 636, *Pipeline Service Obligations & Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. STATS. & REGS. Preambles ¶ 30,939, 57 Fed. Reg. 13,267 (1992), *order on reh'g*, Order No. 6-A, III F.E.R.C. STATS. & REGS. Preambles ¶ 30,950, 57 Fed. Reg. 36,128 (1992), *order on reh'g*, Order No. 636-B, 61 F.E.R.C. ¶ 61,272, 57 Fed. Reg. 57,911 (1992), *aff'd in part and remanded in part*, United Dist. Co. v. FERC, 88 F.3d 1105 (D.C. Cir. 1996) [hereinafter Order No. 636].

5. Elizabeth Pendley, *Deregulation of the Energy Industry*, 31 LAND & WATER L. REV. 27, 29 (1996).

6. Order No. 636, *supra* note 4.

7. Cody L. Graves & Maria Mercedes Seidler, *The Regulation of Gathering in a Federal System*,

To get out from under federal regulation, the interstate pipeline companies decided to "spin-down" their gathering activities into separate, affiliated companies. Company proposals before the FERC required that the FERC decide whether to treat the spin-downs as though they were independent local gathering systems exempt from regulation under the Natural Gas Act[8] (NGA), or whether they were still sufficiently connected to the interstate transport of gas that the FERC still had jurisdiction.[9]

After holding a public conference on gathering, the FERC determined that it would implement its new policy by issuing a series of orders rather than by promulgating new rules.[10] In a leading case in the group, *Arkla Gathering Services Co.*, the FERC decided that it did not have jurisdiction over an affiliated gatherer, but that it would have jurisdiction if the gatherer acted collusively with its parent company.[11] The FERC decision was appealed by a group of producers and affirmed by the D.C. Circuit Court of Appeals in *Conoco v. FERC*.[12]

This Note analyzes the Court's decision in light of the purposes of the NGA and Order No. 636. Part II provides background information on the regulatory goals of the NGA and Order No. 636 and briefly discusses their effects on gathering regulation. Part III discusses the FERC decision under review and the D.C. Circuit's holdings in the case. Part IV analyzes the Court's interpretation of precedent and discusses how the Court balanced the requirements of the NGA and Order No. 636 in affirming the FERC's decision to regulate a gathering affiliate only if it took advantage of its relationship with its parent pipeline and engaged in anti-competitive behavior. The Note's conclusion is that the Court's decision, while reasonable with respect to precedent and the current regulatory scheme, may create confusion and delay in dealing with anti-competitive gatherer behavior should it arise.

II. BACKGROUND

A. *The Natural Gas Act*

The various segments of the natural gas system are subject to regulation by either the states or the federal government. States regulate production to protect the correlative rights of the various owners of the mineral rights in a field. At the other end of the system, states regulate LDCs

15 ENERGY L.J. 405 (1994).

8. The NGA authorizes the FERC to regulate interstate transportation of natural gas and interstate sale of gas for resale. Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w (1994). The argument is that if a gathering company does not sell gas interstate or provide interstate transportation, the FERC has no jurisdiction over it.

9. *Northwest Pipeline Corp.*, 59 F.E.R.C. ¶ 61,115 (1992).

10. Larry Pain, *Gas Gathering in the Age of Competition*, 46 OIL & GAS L. & TAX'N 3-1, 3-5 (1995).

11. *Arkla Gathering Services Co.*, 67 F.E.R.C. ¶ 61,257 (1994).

12. Conoco Inc. v. FERC, 90 F.3d 536 (D.C. Cir. 1996), *cert. denied*, Amoco Energy Trading Corp. v. FERC, 117 S. Ct. 1017 (1997).

to ensure reasonable rates and adequate supplies for local consumers. Early in the history of the natural gas industry, abuses in the interstate transportation of gas, which could not be reached by the states, revealed the need for federal regulation.[13] Congress enacted the Natural Gas Act of 1938[14] to make sure that no part of the system was left open to abuse due to monopoly. The NGA provides for FERC regulation of natural gas companies,[15] but excludes production and gathering from regulation under the act.[16] Historically, production and gathering were under the authority of the state governments,[17] and the NGA was not intended to usurp state authority but to provide regulation in areas which the states could not reach.[18] Despite its indicated exclusion under section 1(b), however, gathering has been regulated when it is part of a "bundled"[19] system offered by an interstate pipeline company because NGA sections 4[20] and 5[21] provide for regulating rates of activities "in connection with" interstate transportation.[22]

13. A few holding companies controlled the pipelines from the Appalachian area to the markets and, therefore, controlled both the producers' market and the consumers' supplies. The holding companies organized their businesses such that some end of the business was outside the reach of any one state commission. Consequently, the cost of natural gas to consumers increased at a greater rate than the price of oil, even though, except for the element of competition, the conditions of production were about the same. FPC v. Hope Natural Gas Co., 320 U.S. 591, 637-638 (1944).

14. 15 U.S.C. §§ 717-717w (1994).

15. The NGA defines a natural gas company as one which sells natural gas interstate for resale or provides interstate transportation of gas. 15 U.S.C. § 717a(6) (1994).

16. NGA § 1(b) states:

> The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural-gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

15 U.S.C. § 717(b).

17. Graves & Seidler, *supra* note 7.

18. H.R. REP. NO. 709, at 1-2 (1937).

19. "Bundled" service is provided by a pipeline which purchases gas at the wellhead and then includes charges for gathering and transportation in the price of the gas. Samuels, *supra* note 3, at 718.

20. NGA § 4 states:

> All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful.

15 U.S.C. §717c(a) (1994).

21. NGA § 5 states:

> No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

15 U.S.C. §717c(b).

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

B. *The Effects of Order Nos. 436 and 636*

By the 1980s, the natural gas industry was not in the best of shape. A gas shortage had been replaced by a gas surplus, pipelines were struggling with take-or-pay contracts left over from the shortage days, and outdated regulations were unable to deal with the current situation which was creating artificially high prices for gas consumers.[23] The FERC interpreted the Natural Gas Policy Act of 1978[24] (NGPA) as a comprehensive natural gas regulatory statute and its section 601(a)(2) as a mandate to regulate to achieve more efficient transportation of gas.[25] In 1985, the FERC issued Order No. 436, which started the process of unbundling gas transportation from sales. The primary goal of that order was non-discriminatory access to pipelines, and participation was voluntary.[26] Order No. 436 forbade any discrimination in transportation charges assessed to the gas of others relative to gas owned by the transporting pipeline. Basically, pipelines were allowed to charge the cost of the transportation plus a reasonable rate of return which would be scrutinized by the FERC.[27] In 1992, the FERC completed the process it started with Order No. 436, issuing Order No. 636 as the finalization of "structural changes in the Commission's regulation of the natural gas industry."[28] This order was intended to address the concerns of non-pipeline gas sellers, pipelines and LDCs which had arisen since the implementation of Order No. 436[29] and to create a "regulatory environment in which no gas seller has a competitive advantage over another gas seller."[30] Order No. 636 requires pipelines to unbundle their

23. William F. Fox, Jr., *Transforming an Industry by Agency Rulemaking: Regulation of Natural Gas by the Federal Energy Regulatory Commission*, 23 LAND & WATER L. REV. 113, 117-118 (1988). Prior to Orders 436 and 636, the pipelines had few incentives to control costs. When gas was in short supply in the 1970s, pipelines bought gas wherever they could get it, at whatever price was demanded. Many of the contracts they entered into contained provisions which required the pipelines to pay for the contracted amount of gas whether the pipeline took it or not (take-or-pay). *Id.*

24. 15 U.S.C §§ 3301-3432. Price-controlled interstate gas was causing gas shortages because producers had no incentive to sell gas at prices which were below the cost of production. The purposes of the NGPA were to remove the distinction between intra and interstate gas and to merge regulation of the two under the FERC, and to gradually decontrol natural gas prices at the wellhead. Fox, *supra* note 23, at 116.

25. Fox, *supra* note 23, at 125-126. The FERC needed some authority from Congress to change the regulatory scheme to address problems in the gas industry, and the FERC interpreted section 601 of the NGPA as providing it. *Id.* at 120-121.

26. The FERC tied special benefits to compliance with the regulations of Order No. 436. A pipeline which provided open access could obtain blanket authorization under section 7 of the NGA to transport gas for others without applying for authorization for each additional transaction. Fox, *supra* note 23, at 128.

27. Fox, *supra* note 23, at 127.

28. Order No. 636, *supra* note 4, at 30,391.

29. Nonpipeline sellers complained that under Order No. 436 they were hampered in long-term sales because their transportation was not comparable to that in bundled service, especially during peak usage. Pipelines complained that improvements in their transportation were limited by obligations to meet the LDCs' requirements. LDCs were concerned about the reliability of transportation in the absence of bundled services. Order No. 636, *supra* note 4, at 30,932.

30. Order No. 636, *supra* note 4, at 30,393.

transportation charges from gas sales and to transport all gas, whether the pipeline is the merchant or not, at the same rates. This new regulatory environment prompted interstate pipelines to spin-down their gathering operations to affiliated companies in an attempt to remove them from federal regulation.[31]

C. *The FERC's Approach to Regulation After Order Nos. 436 and 636*

The FERC first dealt with regulation of gas gathering in the unbundled world in *Northwest Pipeline Corp.*[32] The FERC held that gathering by affiliates is subject to regulation under the NGA,[33] but decided not to use the traditional methods of regulation.[34] Instead, the FERC decided to regulate only if it received complaints about abuse of the corporate relationship by the affiliate and its parent. Affiliates were not automatically required to file gathering rates and conditions of service with the FERC, but they would be required to if the FERC received evidence of discriminatory rates or practices.[35]

The industry move to spin-down gathering led the FERC to consider the implications of discretionary regulation of interstate pipeline affiliates. It proposed a public conference to review the extent to which the FERC should exercise jurisdiction over pipelines and gatherers affiliated with pipelines under sections 4 and 5 of the NGA.[36] After the conference, rather than issuing a set of generic rules, the FERC began implementing its new policies in a series of case orders.[37]

III. STATEMENT OF THE CASE

In 1993, in the leading case dealing with regulation of gatherer affiliates, NorAm Field Services (NAField, formerly Arkla Gathering Services)

31. Conoco Inc. v. FERC, 90 F.3d 536, 541 (D.C. Cir. 1996).

32. *Northwest Pipeline Corp.*, 59 F.E.R.C.¶ 61,115 (1992).

33.

> The general rule ... is that an agency may disregard the corporate form in the interest of public convenience, fairness, or equity .... Corporations may be regarded as one entity for the purposes with which the agency is immediately concerned even though they are legitimately distinct for other purposes .... No bad intention on the part of the corporations is necessary; the inquiry is simply a question whether the statutory purposes would be frustrated by the corporate form.

Id. at 61,435 (quoting Opinion No. 255, 37 F.E.R.C. ¶ 61,149 at 61,356 (1986)).

34. Traditional methods of regulation would require the company to be certificated under section 7 of the NGA and to file gathering rates and conditions of service with the FERC.

35. *Northwest Pipeline*, 59 F.E.R.C. ¶ 61,115.

36. The FERC prepared a list of questions for those participating to consider. These questions indicated issues the FERC thought relevant to determining the approach to gathering regulation. They included questions concerning: competition among gatherers, a requirement that FERC regulate gathering, the adequacy of state regulation, the adequacy of the proposed complaint procedure, and whether pipeline gathering and pipeline affiliate gathering should be treated differently. *Natural Gas Gathering Services Performed by Interstate Pipeline and Interstate Pipeline Affiliates—Issues Related to Rates and Terms and Conditions of Service*, 65 F.E.R.C ¶ 61,136, at 61,691-61,694 (1993).

37. Pain, *supra* note 10, at 3-5.

sought a declaratory order from the FERC that the gathering facilities it would receive from NorAm Gas Transmission Company (NAGas, formerly Arkla Energy Resources Company) would not be subject to FERC regulation under NGA section 1(b).[38] NAField would acquire the gathering operations in a spin-down from NAGas designed to remove the company's gathering facilities from FERC jurisdiction so they would compete more favorably with independent, non-FERC-regulated competitors.[39] A number of interested consumers and producers protested the request.[40] NAField, anticipating that the FERC might not grant its exemption, proposed as an alternative that the gathering rates be subject to "light handed regulation . . . through future complaint mechanisms."[41]

The FERC appeared to accept NAField's suggestion. In deciding *Arkla Gathering Services*, the FERC first used the primary function test and determined that the NAField facilities fit the definition of gathering facilities.[42] Second, it granted the requested exemption from federal regulation provided that the companies do not engage in anti-competitive practices based on the close ties of the gatherer to the interstate pipeline company.[43] Third, to protect NAGas' current customers, the FERC required NAField to negotiate new contracts with NAGas' existing customers or offer default contracts with terms similar to those offered by independent gatherers in the area.[44]

The first two of the FERC holdings were challenged by a number of producing company petitioners (Producers) which believed they would be disadvantaged by FERC's decision not to regulate affiliate gatherers.[45]

38. *Arkla Gathering Serv. Co.*, 67 F.E.R.C ¶ 61,257 (1994) (Arkla I), *order on reh'g, Arkla Gathering Serv. Co.*, 69 F.E.R.C. ¶ 61,280 (1994) (Arkla II); *reh'g denied, Arkla Gathering Serv. Co.*, 70 F.E.R.C. ¶ 61,079 (1995) (Arkla IV); *reconsideration denied, Arkla Gathering Serv. Co.*, 71 F.E.R.C. ¶ 61,297 (1995) (Arkla V). *Arkla Gathering Services Co.*, 70 F.E.R.C. ¶ 61,018 (1995) (Arkla III), *order on reh'g*, Arkla IV, *order on reh'g*, Arkla V.

39. Conoco v. FERC, 90 F.3d 536, 541 (D.C. Cir. 1996).

40. One concern was that NAGas and NAField would use their monopoly power to control access to the NAGas transmission system by manipulating NAField's gathering rates. Another was that NAField would shift costs to wells with no gathering alternatives and potentially force the premature abandonment of some wells. Some argued that removing the gathering function from regulation would frustrate the competitive objectives of Order No. 636. *Arkla I*, 67 F.E.R.C. ¶ 61,257, at 61,869.

41. *Id.* at 61,865.

42. *Id.* at 61,867. The primary function test, used to determine whether a pipeline performs a gathering or transmission function, considers six different factors: length and diameter of the lines; extension of the facility beyond the central point in the field; geographic configuration of the lines; locations of compressors and processing plants; location of wells using the facility; and the operating pressure of the lines. *Farmland Ind., Inc.*, 23 F.E.R.C. ¶ 61,063 (1983); *Amerada Hess Corp.*, 52 F.E.R.C. ¶ 61,268 (1990).

43. *Arkla* I, 67 F.E.R.C at 61,871.

44. *Id.* at 61,872.

45. Producer petitioners: Amoco Energy Trading Corporation, Amoco Production Company, Anadarko Petroleum Corporation, Arkansas Royalty Membership, Conoco, Inc., Independent Petroleum Association of America, Marathon Oil Company, Oklahoma Independent Petroleum Association, Texaco, Inc., and Texaco Natural Gas Inc. Producer intervenors: Exxon Corporation, Commissioner for Public Lands for the State of New Mexico, New Mexico Energy, Minerals and Natural

The third determination, requiring default contracts, was challenged by a group of pipeline/gatherer petitioners and intervenors.[46] The five orders pertaining to the NAField spin-down[47] were reviewed by the D.C. Court of Appeals in *Conoco v. FERC*.[48] The Producers argued that the FERC decision to classify the facilities at issue as gathering facilities was due to a misapplication of the primary function test. They argued that the FERC erred in declining to regulate the gathering rates charged by an affiliate because only the physical aspects of gathering are exempt under section 1(b) of the NGA. The Producers also argued that the FERC's decision is internally inconsistent, that it makes no sense for the FERC to find that it does not have jurisdiction over affiliate gatherers, but that jurisdiction can be created by discriminatory activity by the affiliate. The pipeline/gathering petitioners argued that the FERC had no authority to require default contracts.

The D.C. Circuit held that the FERC adequately considered the factors which are used to define gathering, and therefore refused to substitute the court's judgment for the expertise-based judgment of the FERC.[49] The court granted *Chevron* deference[50] to the FERC's decision regarding jurisdiction over gathering rates charged by pipeline affiliates because there is no controlling precedent and the NGA is ambiguous in this area.[51] The court overruled the FERC's decision regarding default contracts, however, holding that once the FERC found that it did not have jurisdiction over affiliate gatherers under NGA section 1(b), it could not invoke other sections of the NGA to require default contracts.[52]

The Producers' petition for a writ of certiorari was denied.[53] Only the second issue, exemption of affiliated gathering from regulation under the NGA, will be discussed in this paper.

IV. ANALYSIS

A. *Exemption Under Section 1(b) of the NGA-Analysis of Case Precedent*

The D.C. Circuit summarized the questions presented to the FERC in *Conoco* as (1) whether the FERC has jurisdiction over the rates charged

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Resources Department and Vesta Energy Company.

46. Pipeline and gatherer petitioners: NAField, NAGas, and GPM Transmission Corporation. Pipeline and gatherer intervenors: Interstate Natural Gas Association of America and Williams Field Services Company.

47. *Arkla* I, II, III, IV, V, *supra* note 38.

48. Conoco v. FERC, 90 F.3d 536, 543 (D.C. Cir. 1996).

49. *Id.*

50. Chevron v. NRDC, 467 U.S. 837 (1984). If Congress has been silent or ambiguous in a statute, a court reviewing an agency interpretation of the statute must decide only whether the agency's interpretation is reasonable.

51. Conoco Inc. v. FERC, 90 F.3d 536, 544-45 (D.C. Cir. 1996).

52. *Id.* at 552-53.

53. Amoco Energy Trading Corp. v. FERC, 117 S. Ct. 1017 (1997).

by a gatherer that is not a natural gas company,[54] and (2) whether the FERC has jurisdiction over a gatherer which is not a natural gas company if the gatherer is affiliated with a jurisdictional pipeline.[55] The FERC's answers were "no" and "it depends," respectively, and the D.C. Circuit found those answers reasonable.

1. FERC Jurisdiction Over the Rates Charged by a Gatherer

Interstate transportation of gas and interstate sale of gas for resale are both regulated under section 1(b) of the NGA.[56] Gathering and production, however, are specifically excluded from jurisdiction under section 1(b).[57] The Producers argued that the Supreme Court has interpreted section 1(b) as treating regulation of the physical aspects[58] of gathering differently from the regulation of the rates charged for gathering.[59] This distinction has been made because the physical aspects of these activities are truly local in character, while the price charged for the gas or the gathering service is usually passed on to the customers in the interstate market.[60]

The Producers relied on *Colorado Interstate Gas v. FPC* to support their contention that the affiliated gatherer's rates are not exempt under NGA section 1(b). In *Colorado Interstate Gas*, three companies developed a business arrangement by which one company would produce gas in the Panhandle field in Texas, the second company would construct pipelines and transport the gas to Colorado markets, and the third company would arrange for sale of the gas into the local Colorado markets.[61] Although separate companies were involved, the FPC "found that their properties have been operated as a single enterprise."[62] In determining whether the rates charged by the group were excessive, the FPC incorporated the production and gathering facilities into the rate base. Even though section 1(b) of the NGA excludes production and gathering from federal regulation, the Supreme Court held that this methodology was proper when all sections of the NGA were considered.[63] The Court found the use of gathering and production facilities in determining the rate base not to be in

54. For a definition of natural gas company, see *supra* note 15.

55. Conoco v. FERC, 90 F.3d 536, 541 (D.C. Cir 1996).

56. NGA § 1(b), *supra* note 16.

57. NGA § 1(b), *supra* note 16.

58. The physical aspects of gathering excluded from federal regulation are those "physical processes closely connected with the natural gas wells themselves." Russell G. Donaldson, Annotation, *What Constitutes "Production and Gathering of Natural Gas" Excluded from Coverage of Natural Gas Act (15 USCS §§ 717 et seq.)*, 44 A.L.R. FED. 843, 848 (1979). For gathering, this includes the activity of collecting the gas after production and the facilities used to collect and process the gas. *Id.* at 848-50.

59. *Conoco*, 90 F.3d at 545.

60. Interstate Natural Gas Co. v. FPC, 331 U.S. 682, 692-93 (1947).

61. Colorado Interstate Gas v. FPC, 324 U.S. 581 (1945).

62. *Id.* at 585.

63. Because sections 9(a) and 14(b) of the NGA address rate-making, the court finds that § 1(b) must be consistent with them. There is no conflict among the sections if production and gathering facilities are included in the rate base. *Id.* at 602.

conflict with section 1(b) because the Court interpreted the exclusion of production and gathering in section 1(b) to apply to the *activities* of production and gathering, such as "the drilling and spacing of wells and the like."[64] The FPC had only used the values of the facilities in a calculation and had not regulated the facilities themselves. The Producers argued that the circumstances in *Conoco*, where only the rate and not the activity of gathering is being regulated, are analogous to those in *Colorado Interstate Gas.* They claim, therefore, that the affiliate is not exempt under section 1(b) and must be regulated.

The D.C. Circuit, however, interpreted *Colorado Interstate Gas* as holding that the Commission is permitted to "consider gathering costs 'for the purposes of determining the reasonableness of rates subject to its jurisdiction.'"[65] The Court drew a distinction between the agency actions in the two cases. In *Colorado Interstate Gas*, the Court approved agency inclusion of gathering facilities in a rate base to determine rates for jurisdictional bundled services; in *Conoco*, the court approved the agency decision not to directly regulate unbundled (non-jurisdictional) gathering rates. The D.C. Circuit therefore ruled that it is not inconsistent to reach different results in the two cases.[66]

The D.C. Circuit countered the Producer's *Colorado Interstate* argument with *FPC v. Panhandle Eastern Pipeline Co.*, in which the Supreme Court decided that a natural gas company could sell a significant quantity of its reserves without the authorization of the FPC.[67] The natural gas company had used its reserves to justify expanding its pipeline system, and the FPC was concerned that the sale might jeopardize the company's ability to supply its customers with gas.[68] Despite the FPC's concern about the effect on the interstate market, the Court decided that the prohibition against regulation of production[69] meant the FPC had no authority to prevent the sale of gas leases. The Court concluded that using gathering costs for rate making as applied in *Colorado Interstate Gas*[70] was "not a precedent for regulation of any part of production or marketing."[71]

The Producers also urged the court to consider *Interstate Natural Gas Co. v. FPC*,[72] in which the Supreme Court again distinguished between regulation of the physical aspects of gathering and regulation of the rates charged for the service. In *Interstate Natural Gas*, the petitioner gathered gas and sold it to three pipeline companies. The Supreme Court agreed

64. *Id.* at 603.

65. Conoco Inc. v. FERC, 90 F.3d 536, 546 (D.C. Cir. 1996) (quoting *Colorado Interstate*, 324 U.S. at 603).

66. *Id.*

67. The D.C. Circuit listed the precedent cited by the Producers and then cited *Panhandle Eastern* as stating a position clearly contrary. *Conoco*, 90 F.3d at 545 n.19.

68. FPC v. Panhandle Eastern Pipe Line Co., 337 U.S. 498, 507-08 (1949).

69. NGA § 1(b), *supra* note 16.

70. Colorado Interstate Gas Co. v. FPC, 324 U.S. 581 (1945).

71. *Panhandle Eastern*, 337 U.S. at 506.

72. 331 U.S. 682 (1947).

with the FPC that the petitioner was not exempt under section 1(b) of the NGA, even though it performed a gathering service, because it engaged in the jurisdictional activity of interstate sale of gas.[73] Although the Court recognized that the purpose of the NGA was to regulate in areas where the states could not,[74] it found that the rates charged for gathering, as opposed to the physical aspects of gathering, were of national rather than local importance.[75] The D.C. Circuit distinguished *Interstate Natural Gas* from *Conoco* because the gatherer in *Interstate Natural Gas* engaged in the jurisdictional activity of interstate sales as well as gathering, where the gatherer in *Conoco* did not.[76]

In summary, the D.C. Circuit found reasonable the FERC's decision that the affiliate was not a natural gas company engaged in interstate sale or transportation of gas as required under section 1(b) of the NGA, so the affiliate's rates were exempt from FERC regulation. While some Supreme Court cases held that the physical aspects of gathering or production, rather than rates, were the aspects of the natural gas system exempted under section 1(b), the D.C. Circuit held these cases inapposite because they involved situations in which the gathering was done in connection with a jurisdictional activity, such as transportation or sales.[77] The question remained, however, of whether gathering done by a pipeline affiliate is done "in connection with" the jurisdictional activity of the pipeline and therefore subject to regulation.

2. FERC Jurisdiction Over a Gatherer Affiliated With a Jurisdictional Pipeline

The Producers argued that there is a jurisdictional hook to bring affiliate gathering under the jurisdiction of the FERC. They analogized the affiliate's situation to that of any other pipeline-owned gatherer, and cited the Eighth Circuit's finding of jurisdiction under sections 4 and 5 of the NGA in *Northern Natural*.[78] In that case, the Eighth Circuit reviewed a FERC decision relating to the regulatory changes of Order No. 436. That order sought to increase competition in the natural gas market by reducing the regulation of pipelines which offered unbundled gas transportation.[79]

73. *Id.* Although the gatherer's pipelines did not cross state lines, its gas sales were held to be in interstate commerce. Gas flowed from the gatherer's wells into the gatherer's pipelines where it was commingled with gas purchased by the gatherer from other producers (which had already been gathered). It then flowed to the purchasers' pipeline in a continuous process with no interruption for storage or processing. *Id.* at 684-85.

74. *Id.* at 690.

75. *Id.* at 692.

76. The Producers also cited several other cases to support their contention that only the physical aspects of gathering are exempt under NGA § 1(b). *Conoco*, 90 F.3d at 545 n.19. The D.C. Circuit found that in each case which allowed jurisdiction over gathering, the gatherer also engaged in some other jurisdictional activity. *Id.* at 545.

77. *Id.* at 545.

78. Northern Natural Gas Co. v. FERC, 929 F.2d 1261 (1991).

79. *Id.* at 1263-64.

To receive the streamlined treatment,[80] the pipelines were required to accept third party gas for transport and publish separate charges for gathering, storage and transportation.[81] A pipeline company challenged FERC's jurisdiction over gathering and therefore over its ability to require a statement of gathering rates.[82] The court held that gathering is not exempt under NGA section 1(b) when the gathering is part of a bundled service provided by an interstate pipeline company.[83] The court's interpretation of NGA sections 4 and 5 was that the FERC could regulate rates charged for a pipeline's own gathering facilities because the gathering was done in connection with interstate transportation.[84] In a footnote, the court went so far as to define gathering facilities owned by a pipeline as including "facilities owned or operated directly or indirectly by a pipeline or its parent, affiliate, subsidiary or lessors."[85]

Because the court in *Northern Natural* concluded that the FERC could regulate gathering rates on a pipeline's own facilities in connection with jurisdictional transportation, and included affiliated facilities in the definition of a pipeline's "own," the Producers argued in *Conoco* that the gathering rates of the affiliate may be regulated. The D.C. Circuit rejected these arguments. First, it found an appreciable difference between the bundled service analyzed in *Northern Natural* and the unbundled, affiliate-provided service in *Conoco*.[86] According to the court, gathering was still bundled to interstate transportation in *Northern Natural*, but not in *Conoco*. The court refused to give much weight to the footnote[87] in *Northern Natural* which directly linked pipeline affiliates to its statement that NGA sections 4 and 5 permit the FERC to regulate gathering rates for a pipeline's own facilities. The court indicated that because the issue of affiliate gathering was not before the court in *Northern Natural*,[88] the full ramifications of its comment in the footnote may not have been sufficiently considered.[89]

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80. *See supra* note 26.

81. *Northern Natural*, 929 F.2d at 1264.

82. *Northern Natural*, 929 F.2d 1261.

83. *Id.* The Tenth Circuit apparently disagreed with the Eighth Circuit on this issue. *See* Northwest Pipeline Corp. v. FERC, 905 F.2d 1403 (10th Cir. 1990); Pain, *supra* note 10, at 3-5; Angela S. Chitwood-Beehler, Comment, *A Conflict in the Circuits: The FERC's Jurisdiction Over Gathering Rates*, 13 ENERGY L.J. 375 (1992). Pain criticizes the *Northern Natural* decision because 1) the Court ignored the phrase "subject to the jurisdiction of the Commission" which is part of NGA §§ 4 and 5, 2) the FERC gets its authority from section 1 of the NGA and not from sections 4 and 5, and 3) a perceived need for regulation can't create jurisdiction when the statute specifically excludes gathering. Pain, *supra* note 10, at 3-5.

84. *Northern Natural*, 929 F.2d at 1273.

85. *Id.* at 1263 n.2.

86. Conoco v. FERC, 90 F.3d 536, 546 (D.C. Cir. 1996).

87. *Northern Natural*, 929 F.2d at 1263 n.2.

88. The court said "[t]he question is not before us of whether gathering performed by producers or independent gatherers for transportation in interstate commerce by an interstate pipeline is sufficiently connected to interstate transportation to justify rate regulation under §§ 4 & 5." *Id.* at 1274.

89. *Conoco*, 90 F.3d at 546-47.

The significance of the footnote depends on how similar the *Northern Natural* court found pipeline-owned gathering and affiliate gathering to be. At one end of gatherer/pipeline relationships is the independent-gatherer or producer-gatherer, which has no corporate connection with any interstate pipeline. At the other end is the gatherer which is part of the interstate pipeline company. In between these two extremes is the organization created in a spin-down in which the gathering operation is run by an affiliate of the interstate pipeline. The Eighth Circuit specifically stated that it was not deciding whether the independent-gatherer or producer-gatherer would be subject to FERC jurisdiction.[90] But in stating the issue of the case as "whether the [FERC] may, in implementing [Order 436], regulate the rates that natural gas pipeline companies charge third-party interstate transportation shippers for moving natural gas on *gathering facilities owned by the pipeline*"[91] (footnote omitted, emphasis added), the Court defined the *gathering facilities owned by the pipeline* as including facilities owned or operated directly or indirectly, and included a pipeline affiliate.[92] The Eighth Circuit defined the scope of its analysis and, contrary to the D.C. Circuit's reading, it appears to have included pipeline affiliates, such as the one at issue in *Conoco*, in the category of pipeline-owned gathering. The Eighth and D.C. Circuits appear to disagree about sections 4 and 5 jurisdiction for pipeline affiliate gatherers.

Finally, the Producers argued that the FERC cannot both deny that it has jurisdiction over affiliate gathering and claim that it has jurisdiction under certain circumstances. They argued that if the FERC claimed gathering could be regulated under some circumstances, then the FERC was acknowledging that it had jurisdiction.[93] In response to this argument, the court discussed the rationale that the FERC had used in some of its orders relating to its regulation of affiliates. The court quoted FERC orders in *Northwest Pipeline* and *Arkla II* which indicate that the FERC has the flexibility[94] and the obligation under the NGA[95] to assert jurisdiction when

90. *See supra* note 88.

91. *Northern Natural*, 929 F.2d at 1262-63.

92. *Id.* at 1263 n.2.

93. "[T]he commission cannot have it both ways. Either it has jurisdiction over the gathering service spun down to the affiliate or it does not. By asserting the potential of future exercise of jurisdiction, the Commission is acknowledging that it has jurisdiction." *Conoco*, 90 F.3d at 548 (quoting Conoco's brief).

94. The FERC has relied on:

> [t]he general rule . . . that an agency may disregard the corporate form in the interest of public convenience, fairness, or equity. This principle of allowing agencies to disregard corporate forms is flexible and practical in nature. Corporations may be regarded as one entity for the purposes with which the agency is immediately concerned even though they are legitimately distinct for other purposes.

Northwest Pipeline, 59 F.E.R.C. ¶ 61,115 at 61,435 (1992) (quoting Opinion No. 255, 37 F.E.R.C. ¶ 61,149 at 61,356 (1986)).

95. The FERC has:

> no authority to regulate an affiliated gatherer because it is not a natural gas company under the NGA . . . . [I]f circumstances develop that would allow the pipeline and its affiliated gath-

corporate behavior indicates a need for regulation. The court explained that the FERC, realizing the potential for abuse, required the pipeline NAGas to add open-access, non-discrimination and anti-tying provisions to its tariff and described some of the affiliate abuses which would result in its asserting jurisdiction.[96] The court summarized the FERC position as being aware that the potential for illegally cooperative behavior exists and found that the FERC has consistently regulated gathering when it is intertwined with jurisdictional activity,[97] which it would be in *Conoco* only if the gatherer affiliate and pipeline acted cooperatively.

The Producers then argued that the FERC was being inconsistent in its decisions about whether or not it has jurisdiction over affiliate gatherers.[98] In an earlier decision, the FERC found that it *did* have jurisdiction over affiliates, but chose not to exercise it.[99] In the decision on appeal in *Conoco*, the FERC stated that it *did not* have jurisdiction, but that jurisdiction would be created if the affiliate and pipeline act in collusion. The Producers claimed that the FERC continued to be inconsistent when it next found that its jurisdiction could not be defeated by the use of affiliates.[100] The Producers cited cases in which interstate pipelines were affiliated to effectively create an interstate pipeline.[101] The court did not recognize any inconsistency because the cases cited involved "chains of interconnected intrastate affiliates that functioned as interstate pipelines."[102] The court found this result consistent with previous FERC decisions which held that gathering intertwined with jurisdictional activities will be regulated by the FERC.[103]

> erer to engage together in anti-competitive activity, the Commission will exert jurisdiction over the gathering service to the extent needed to preserve the Commission's statutory mandates under the NGA.

Arkla II, 69 F.E.R.C. ¶ 61,280 at 62,087 (1994) (discussing *Northwest Pipeline*, 59 F.E.R.C. ¶ 61,115 at 61,435-36).

96. *Conoco*, 90 F.3d at 548. Abuses related specifically to the relationship between the pipeline and affiliate would trigger FERC assertion of jurisdiction. Suspicious actions include the gatherer tying gathering to the pipeline's transportation, the pipeline giving discounts to those using the affiliate's gathering service, and cross-subsidization of affiliate gathering and pipeline transportation rates. *Arkla I*, 67 F.E.R.C. ¶ 61,257 at 61,871 (1994).

97. *Conoco*, 90 F.3d at 549.

98. *Id.* at 548 n.25.

99. *Northwest Pipeline*, 59 F.E.R.C. ¶ 61,115 at 61,435-36.

100. Conoco's Joint Initial Brief at 24, Conoco Inc. v. F.E.R.C., 90 F.3d 536 (D.C. Cir. 1996) (No. 94-1724) [hereinafter Conoco's Brief].

101. KansOk Partnership v. Williams Natural Gas Co., 73 F.E.R.C ¶ 61,160 (1995), *order granting stay in part*, 73 F.E.R.C. ¶ 61,293 (1995). The 1000-mile pipeline system consisted of KansOk, a pipeline entirely in Oklahoma; Kansas Pipeline, a pipeline entirely in Kansas; and Riverside, which consisted of one-mile segments which served to cross the Oklahoma-Kansas border and a two-mile segment which crossed the Kansas-Missouri border. Louisiana Gas System Inc. v. Panhandle Eastern Corp., 73 F.E.R.C. ¶ 61,161 (1995). The 70-mile proposed pipeline system would transport gas from a storage facility in Texas to an affiliated interstate pipeline in Louisiana.

102. *Conoco*, 90 F.3d at 548 n.25.

103. *Conoco*, 90 F.3d at 549.

The Producers also argued that jurisdiction is not discretionary.[104] They argued that the *Conoco* situation is similar to that in *Maislin Industries v. Primary Steel, Inc.*, in which the Interstate Commerce Commission (ICC) decided to allow a shipper to pay a negotiated rate which was lower than the filed rate.[105] The Supreme Court disagreed with this policy, saying that it conflicted with the governing statute.[106] With motivation similar to that of the FERC in the instant case, the ICC was trying to adjust its regulations to suit a more competitive environment.[107] The Supreme Court found that "[a]lthough the Commission has both the authority and expertise generally to adopt new policies when faced with new developments in the industry, . . . it does not have the power to adopt a policy that directly conflicts with its governing statute."[108]

The Producers also cited *MCI Telecommunications Corp. v. AT&T*[109] as supporting their claim that jurisdiction is not discretionary. The Federal Communications Commission (FCC) had issued a series of orders which essentially deregulated the nondominant[110] long distance telephone companies, even though the Communications Act of 1934, section 203(b)(2),[111] required that common carriers file their rates and charge only the filed rate. Even though the FCC acted to further the "broad purpose of promoting efficient telephone service," the Supreme Court held that its *Maislin* logic applied.[112] Without specifically discussing either *Maislin* or *MCI*, the D.C Circuit agreed with the FERC that determination of jurisdiction over gatherer affiliates is discretionary and that their decision was not internally contradictory and was entitled to judicial deference.[113]

While *Maislin* and *MCI* at first seem analogous, a closer examination of the statutes involved indicates that those cases are not determinative of the issue in *Conoco*. The statutes in *Maislin* and *MCI* had been interpreted by the courts as specifically requiring regulation, and the agencies had no discretion with respect to regulation. In contrast, the courts had not determined the scope of agency discretion to regulate gathering under the NGA. The D.C. Circuit held that there was no precedent prescribing whether an affiliate gatherer comes under FERC jurisdiction; similarly, there was no precedent which prevented the FERC from treating jurisdiction as discretionary.

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104. Conoco's Brief, *supra* note 100, at 25-26.

105. 497 U.S. 116 (1990).

106. *Id.* at 134-135. The purpose of the Interstate Commerce Act is to ensure that rates charged by motor common carriers in interstate commerce are just and reasonable. The Act requires a motor common carrier to publish and file its rates with the ICC and specifically prohibits charging any rate other than the filed rate.

107. *Id.* at 133.

108. *Id.* at 134-135.

109. 512 U.S. 218 (1994).

110. American Telephone and Telegraph Company was the only dominant long distance carrier.

111. Communications Act of 1934, § 203(b)(2), as amended, 47 U.S.C.A. § 203(b)(2) (1991).

112. *MCI*, 512 U.S. at 232.

113. Conoco v. FERC, 90 F.3d 536, 549 (D.C. Cir. 1996).

B. *Policy Considerations*

In *Conoco*, the court observed that the decisions cited by the Producers to demonstrate how the courts have interpreted section 1(b) all predated Order Nos. 436 and 636, orders which caused a major restructuring of the natural gas industry.[114] It appears that the FERC has some potentially conflicting responsibilities under the NGA and the recent FERC orders.

1. Responsibilities Under the NGA

Under the NGA, the FERC is charged with protecting gas consumers from the exercise of monopoly power by pipelines in order to ensure consumers of an adequate supply at reasonable prices.[115] The federal agency was not meant to replace state regulation, but to provide regulation where the states could not act.[116] Early in its evaluation of whether to regulate gathering rates, the FERC decided that regulation of the rates, terms, and conditions of gathering under the open-access provisions of Order No. 436 is of national, rather than local, concern so that federal, rather than state,[117] regulation is most appropriate.[118] The FERC's view was that because Congress' intent was to "close all gaps in the regulation of the movement and sale of natural gas," it gave the FERC authority to regulate the rates, terms and conditions of gathering performed in connection with open-access transportation.[119] When there is some doubt as to whether the state can practically regulate in an area, the FERC found that federal authority governs.[120]

The *Conoco* court recognized the need to regulate to prevent anticompetitive behavior. The court observed that the Eighth Circuit in *Northern Natural* was motivated to find jurisdiction over a pipeline-owned gatherer by a concern that unregulated gathering would effectively permit the pipeline to provide favorable rates for its own gas compared to third-party shippers.[121] The court stated that this particular concern was the part of the *Northern Natural* opinion which best supported the Producer's argument.[122] The *Conoco* court acknowledges the potential for abuse, but seems willing to allow the FERC to test the waters of deregulation brought

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114. *Id.* at 545.

115. Samuels, *supra* note 3.

116. H.R. REP. NO. 709, at 1-2 (1937).

117. Authority for regulation of production and gathering has historically belonged to the states. States have reason to regulate when independent gatherers have enough market power to control producer's access to the market. Graves & Seidler, *supra* note 7, at 407. The effects of anti-competitive behavior by gatherers may be felt most strongly at the state level by producers which are disadvantaged in the marketplace because their wells are connected to high priced gathering systems. Graves & Seidler, *supra* note 7, at 423.

118. *Northern Natural Gas Co.*, 43 F.E.R.C. ¶ 61,473, at 62,161 (1988).

119. *Id.* at 62,162.

120. *Id.*

121. Northern Natural Gas Co. v. FERC, 929 F.2d 1261, 1270 (8th Cir. 1991).

122. Conoco v. FERC, 90 F.3d 536, 547 (D.C. Cir. 1996).

about by Order Nos. 436 and 636.

2. New Goals of a Competitive Market

Order Nos. 436 and 636 indicate a shift in the policies of the FERC to deregulation of the natural gas industry which will result in competition and market-based prices. The industry has been transformed by unbundling gas transmission costs and providing open-access to interstate pipelines. Now, competition rather than regulation is the force protecting the consumer from unjust pricing.[123] This shift has occurred at the initiative of the FERC without any changes in the underlying enabling acts, and for the most part, the courts have gone along with the FERC's innovations.[124]

3. The Compromise

Order No. 636 should make regulation of gathering less necessary. With the price of gas deregulated and the interstate pipelines open to third-party shippers on an equal basis, end-users can bargain for the best supplies of gas.[125] The FERC's approach is that deregulation should be the best method for optimizing the price and service for the consumer, but that the FERC must remain vigilant in preventing any abuses due to monopoly. Therefore, the FERC's decision to regulate an affiliate gatherer only when there is abuse of the affiliate/parent relationship represents a compromise between its responsibilities under the NGA and its vision of an efficient, market-driven natural gas industry. The D.C. Circuit joins other courts in allowing the FERC to interpret, essentially on its own, the direction the natural gas industry should take.[126]

C. Consequences

The *Conoco* court reviewed a FERC decision which balanced the regulatory requirement of the NGA against the deregulated, market-driven approach of Order No. 636. The balance tipped in favor of Order No. 636 because the FERC will not regulate unless there is evidence of anticompetitive action on the part of the gatherer and its affiliated pipeline. Whether there will be abuse under this system and how effectively discretionary regulation will handle anticompetitive situations remains to be seen. Perhaps gathering is sufficiently competitive that problems will be few. In 1995, only about thirty percent of gathering was done by interstate pipelines.[127] The other seventy percent of the activity "aroused very little controversy or complaint."[128]

123. Graves & Seidler, *supra* note 7, at 413.

124. Fox, *supra* note 23, at 113.

125. Graves & Seidler, *supra* note 7, at 418-19.

126. *See* Fox, *supra* note 23, at 113-14. The Fifth Circuit also affirmed a FERC decision that an affiliated gatherer is not subject to FERC regulation. Pacific Gas & Elec. Co. v. FERC, 106 F.3d 1190 (5th Cir. 1997).

127. Pain, *supra* note 10, at 3-3.

128. *Id.*

An obvious problem is uncertainty as to what circumstances will trigger FERC jurisdiction. *Conoco* itself provides the first illustration of the problem. One of the FERC decisions reviewed in *Conoco*, which was not discussed in this Note, was to exercise jurisdiction and require assurances that the gathering service provided to existing customers "would not be arbitrarily terminated in the event of a spin-down . . . or offered only at unreasonable terms, conditions, and rates."[129] The FERC required NAGas to show that it had either negotiated private contracts with its existing customers or had offered them default contracts with terms similar to those offered by independent gatherers in the same area.[130] FERC required default contracts to "provide a transitional period during which a pipeline's existing customers could consider their options and the states could implement any policies they deemed necessary in the absence of federal regulations of gathering."[131] The Court overruled the FERC's attempt to exercise jurisdiction and require these contracts, stating that once the section 1(b) exclusion was found to apply, the provisions of sections 4, 5, and 7 could not be applied to create jurisdiction.[132]

Thus, the FERC itself had trouble identifying the circumstances under which it can exercise jurisdiction. If the FERC has problems interpreting the new regulatory scheme, the industry will have difficulty also. As an alternative to seeking relief from the FERC, those harmed by unlawful gatherer activity have the options of state law and federal antitrust law to provide remedies.[133]

V. CONCLUSION

The *Conoco* court held that an affiliate gatherer is not a natural gas company; therefore, it is not subject to regulation by the FERC unless its activities are intertwined with jurisdictional activities. An interstate pipeline company's gathering will be viewed as intertwined with jurisdictional activities, and subject to regulation by FERC, if the gatherer and affiliated pipeline engage in anticompetitive behavior.

This approach to regulation of affiliate gatherers is a compromise between the NGA's goals of consumer price protection and adequate supply and Order No. 636's goal of increased competition in the natural gas market. The flexibility of the approach should lower gas gathering rates, but creates some uncertainty about how the regulatory scheme will deal with abuses.

Janet Gulbis, Ph.D.

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129. *Conoco*, 90 F.3d at 541-542.
130. *Id.* at 542.
131. *NorAm Gas Transmission Co.*, 78 F.E.R.C. ¶ 61,265 (1997).
132. *Conoco*, 90 F.3d at 552.
133. First Nat'l Oil, Inc. v. FERC, 102 F. 3d 1094, 1097 (10th Cir. 1996).