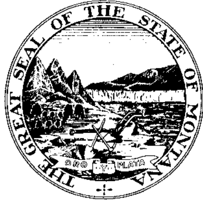

Revenue and Transportation Interim Committee

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59th Montana Legislature

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December 2, 2005

TO: Revenue and Transportation Committee

FROM: Jeff Martin, Legislative Research Analyst

SUBJECT: History of the Regulation of Natural Gas

As part of the House Joint Resolution No. 44 study of the property taxation of oil and natural gas property, this memorandum presents a brief history of the regulation of the supply of natural gas, focusing primarily on federal regulatory policy.

A Very Brief History of the Regulation of Natural Gas[1]

The first regulation of natural gas was initiated by municipalities in the mid-1800s. Natural gas was produced from coal for delivery to the municipality. Municipalities determined that a single provider could deliver natural gas more efficiently than several providers. However, because of the monopolistic characteristics of a single provider of natural gas, municipal authorities regulated rates and other aspects of the market in the public interest. As natural gas distribution expanded within a state, the state took over the regulatory responsibilities with the establishment of public utility commissions or public service commissions.

In the early 1900s, as technology improved for transporting natural gas, pipeline companies began the interstate shipment of natural gas. Between 1911 and 1928, some states attempted to assert regulatory oversight of interstate natural gas pipelines. However, the U.S. Supreme Court ruled that state regulation of interstate pipelines violated the Commerce Clause of the U.S. Constitution. It was not until 1938, with the enactment of the Natural Gas Act, that the federal government asserted regulatory control of interstate pipelines. The act gave the Federal Power Commission[2] the authority to regulate rates that interstate pipelines (natural gas companies) could charge for interstate delivery of natural gas and, under amendments adopted in 1942, to certify the construction of new pipelines. The purpose of the act was to protect consumers by

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[1]The discussion on the regulation of natural gas draws heavily from "The History of Regulation" (NaturalGas.org, 2004, available from http://naturalgas.org/regulation/history.asp; Internet; accessed November 22, 2005).

[2]Congress created the Federal Power Commission in 1920 to coordinate hydroelectric projects under federal control.

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ensuring "just and reasonable" prices for natural gas and a "fair profit" for natural gas companies.[3]

The Natural Gas Act specifically exempted the production and gathering of natural gas from regulation because the states had the authority to regulate local production and gathering and because, unlike the interstate transportation of natural gas, production and gathering were generally competitive.[4] In a series of cases decided in the 1940s, the U.S. Supreme Court ruled that natural gas producers that were affiliated with purchasing pipelines were subject to federal regulation. Based on those decisions, the Federal Power Commission determined that producers that were not affiliated with a pipeline were not subject to regulation. In particular, the commission conducted an investigation of whether Phillips Petroleum Co. was a natural gas company under the Natural Gas Act. The company was engaged in the production, gathering, processing, and sale of natural gas. It sold its gas to five interstate pipelines. The commission concluded that its jurisdiction did not extend to Phillips Petroleum. However, the U.S. Supreme Court came to the opposite conclusion by ruling that the company "is a 'natural-gas company' within the meaning of the Natural Gas Act, and its sales in interstate commerce of natural gas for resale are subject to the jurisdiction of, and rate regulation by, the Federal Power Commission."[5] The Court determined that the "sales by this Company are not part of the 'production or gathering of natural gas,' which are excluded from the Commission's jurisdiction. . ., since the production and gathering end before the sales occur."[6]

As a result of this decision, the Federal Power Commission gained additional regulatory authority of natural gas markets. Over the years, it adopted a number of pricing schemes for natural gas producers that sold gas to interstate pipelines. These included treating each producer as a public utility and setting prices based on cost of service; setting rates based on geographic area; and establishing national price ceilings. Each of these approaches inhibited natural gas production by maintaining artificially low prices. As a result, the interstate demand for natural gas exceeded the supply, which over time led to shortages.

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[3]Castaneda, Chrisopher, review of *The Natural Gas Market: Sixty Years of Regulation and Deregulation*, by Paul MacAvoy. Economic History Services (http://www.eh.net/bookreviews/library/0385.shtml; Internet, accessed August 8, 2005) pp. 1-4.

[4]Bryce, David V., "Pipeline Gathering in an Unbundled World: How FERC's Response to 'Spin Down' Threatens Competition in the Natural Gas Industry", *Minnesota Law Review*, Vol. 89, No. 2 , obtained from Thomson/West (Minneapolis, MN: Minnesota Law Review Foundation, December, 2004) p. 4.

[5]Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

[6]*Ibid*.

In 1978, Congress enacted the Natural Gas Policy Act to deal with natural gas shortages in interstate markets by providing for the gradual deregulation of wellhead prices of natural gas. More competitive prices and long-term "take-or-pay" contracts with producers led to an oversupply of natural gas.

Deregulation took another step forward in the early 1980s when large customers of natural gas who had the capability of switching their source of energy were allowed to purchase natural gas directly from the producer. These arrangements were ruled discriminatory because other customers (e.g., local distribution companies) were not allowed to purchase natural gas from the producer. However, the Federal Energy Regulatory Commission[7] decided that there would be advantages to allowing customers to purchase directly from producers. In 1985, it issued Order No. 436 to permit interstate pipelines to voluntarily offer transportation services to customers on a "first come, first served basis." FERC established a range of prices that pipelines could charge for transportation services, but otherwise pipelines were allowed to transport gas for others at competitive rates. The new rule (referred to as the Open Access Order) began the process of changing the function of interstate pipelines from providing bundled services (an integrated supply system that was capable of delivering natural gas from the wellhead to the ultimate retail gas consumer[8]) to providing transportation services.

In 1987, FERC issued Order No. 500 to encourage interstate pipelines to buy out take-or-pay contracts. Pipelines were allowed to pass on a portion of those costs to local distribution companies who in turn were allowed to pass on these costs to retail customers.

The move to deregulate most natural gas prices at the wellhead occurred in 1989 with the enactment of the Natural Gas Wellhead Decontrol Act. Under the act, all federal regulation of prices at the wellhead for the first sale of natural gas were eliminated on January 1, 1993. The term "first sale" means the sale of natural gas:

- to an interstate or intrastate pipeline;
- to a local distribution company;
- to a person for use by the person;
- that precedes the sale to any of the above businesses;
- as determined by the Federal Energy Regulatory Commission.

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[7]The Federal Energy Regulatory Commission replaced the Federal Power Commission under the Department of Energy Organization Act of 1977.

[8]"FERC Policy on Natural Gas Gathering System Ownership Since 1992", Energy Information Administration, U.S. Department of Energy (Energy Information Administration: Washington, D.C., modified on January 7, 2005, available from http://www.eia.doe.gov/oil_gas/natural_gas/analysis_publications/ngmajorleg/fercpolicy.html; Internet; accessed November 11, 2005) p. 1.

The first sale of natural gas does not include the sale by an interstate or intrastate pipeline, local distribution company, or any affiliates of these businesses unless produced by the business.[9]

In 1992, FERC issued Order No. 636 to require interstate natural gas pipelines to separate, by November 1, 1993, their transportation and sales services and to transport natural gas for all qualified shippers on a nondiscriminatory basis. The order meant that all pipeline customers "have a choice in selecting their gas sales, transportation, and storage services from any provider, in any quantity."[10] Although pipelines were not permitted to sell any product as a bundled service, they could still provide a variety of services, such as gathering and storage. However, the trend has been to establish separate production and marketing affiliates, many pipeline companies having transferred their unbundled services to another corporate entity.[11] While FERC still has regulatory authority over pipelines and storage, natural gas purchases are essentially free from regulation.[12]

Gathering systems accumulate and transport natural gas from a well to an acceptance point of a transportation pipeline. In the past, FERC used two tests to distinguish jurisdictional transportation of natural gas from nonjurisdictional gathering systems. Under the "behind-the-plant" test, pipelines upstream of compressors and processing plants (toward the wellhead) were considered gathering lines, while pipelines below the plants were considered transportation systems. Under the "central-point-in-the-field" test, lateral lines that collected and transported natural gas that required no processing from separate wells that then converged into a single large line were considered gathering lines, while pipelines downstream of the collection were considered transmission lines. In 1983, FERC adopted a "primary function" test that takes into account several physical and nonphysical factors.[13] The physical factors include:

- the length and diameter of the pipeline (longer and wider pipelines indicate a transportation system);
- the extension of pipeline beyond the central point in the field;
- the pipeline's geographic configuration (a weblike pattern indicates a gathering system);

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[9]See 15 U.S.C. 3301(21).

[10]NaturalGas.org, *op. cit.*, p. 10.

[11]"Natural Gas 1994: Issues and Trends", Energy Information Administration, U.S. Department of Energy (Energy Information Administration, Office of Oil and Gas: Washington, D.C., July 1994 http://www.eia.doe.gov/pub/oil_gas/natural_gas/analysis_publications/natural_gas_1994_issues_trends/pdf/056094.pdf; Internet, accessed November 11, 2005) p. 39.

[12]*Ibid.*, p. 1.

[13]These factors were instituted primarily to deal with production and gathering of natural gas occurring on the Outer Continental Shelf. Apparently, these factors work fairly well for on-shore gathering and production, but several off-shore companies have challenged FERC's determinations.

- the location of compressors and processing plants ("behind-the-plant" test);
- the location of wells along all or a part of the facilities (indicates a gathering system); and
- the operating pressure of the pipeline (higher pressure needed to propel gas indicates a transportation system).[14]

The nonphysical factors include:

- the purpose, location, and operation of the pipelines;
- the general business activity of the owner of the pipeline;
- whether a jurisdictional determination (i.e., gathering versus transmission) is consistent with the objectives of the Natural Gas Act and other legislation; and
- the changing technical and geographic nature of exploration and production activities.[15]

Under the primary function test, no one factor is determinative, nor do all factors apply in every situation.[16] Despite these physical and nonphysical factors, it may not always be clear whether a particular portion of pipeline should be treated as gathering lines or transmission lines.

Changes in federal and state regulatory policy have significantly changed the structure of natural gas markets. The Revenue and Transportation Committee may want to evaluate what significance these changes mean in Montana as it examines the issues raised in House Joint Resolution No. 44.

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[14]ExxonMobil Gas Mktg. Co. v. FERC, 297 F.3d 1071, 1076-77 (D.C. Cir. 2002).

[15]*Ibid.*

[16]Energy Information Administration, "FERC Policy on Natural Gas Gathering System Ownership Since 1992", *op. cit*., p. 2.