

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION OF THE IMPACT OF FEDERAL)
POLICY ON NATURAL GAS TO KENTUCKY) ADMINISTRATIVE
CONSUMERS AND SUPPLIERS) CASE NO. 297

O R D E R

On November 23, 1992, Franklin Circuit Court remanded this case with instructions that the Commission reconsider its Order of October 23, 1987 in light of recent federal court decisions.¹ At issue is the jurisdictional status of interstate pipelines transporting natural gas to end-users. Finding that the present state of the law conflicts with its earlier decision, this Commission amends its Order of October 23, 1987 to conform with current precedent.

Begun in January 1986, this investigation was the Commission's response to the efforts of the Federal Energy Regulatory Commission ("FERC") to deregulate segments of the natural gas industry and stimulate competition. All major local distribution companies ("LDCs") and many large gas suppliers, transporters, and end-users within the Commonwealth participated.

Among the issues considered was the potential disruptive impact of "physical bypass" of the transmission and distribution plant of LDCs. Many parties feared that large industrial customers

¹ Newport Steel Corp. v. Pub. Serv. Comm'n, No. 87-CI-1652, slip op. at 1-2 (Franklin Cir. Ct. Nov. 23, 1992)

might leave an LDC's system and engage in such transactions, depriving the LDC of needed revenue and forcing it to increase its retail rates for residential and commercial users. It was also feared that physical bypass of LDCs would result in the construction of unneeded and wastefully duplicative facilities.

Addressing these concerns in its final Order, the Commission stated:

The Commission finds that a utility proposing physical bypass of an LDC in order to accommodate the use of natural gas by an end-user should be required to make application to this Commission requesting a certificate of convenience and necessity to bypass the LDC. No construction of any sort should be permitted before the certificate proceedings are completed. The Commission finds this necessary to prevent duplication of facilities and to protect the public interest.

Order of 5/29/87 at 63.

Uncertain whether the Commission was requiring certificates for public convenience and necessity for certain facilities connected to an interstate pipeline for the transportation of gas, Kentucky Industrial Utility Customers ("KIUC") applied for rehearing and requested clarification on the Order's application to interstate pipelines serving end-users. In its October 23, 1987 Order on Rehearing, the Commission stated:

[T]he term "utility supplier" does include an interstate pipeline. The utility supplier is that entity connecting directly with the end-user and is thus providing the distribution function.

For example, in instances where an end-user constructs facilities to tie into an interstate pipeline, the interstate pipeline, as the utility, must make application for a

certificate of convenience and necessity for the tap. Should a third party propose to own the pipeline connecting the end-user and the interstate pipeline, that third party would be considered an intrastate pipeline or transporter. The third party would become subject to the Commission's jurisdiction. A certificate would be required for the third party to construct the pipeline or the tap that will directly serve the end-user.

Order of 10/27/87 at 12.

KIUC thereupon brought an action for review of the October 23, 1987 Order and for declaratory judgment on the Order's constitutionality. It contended that the Commission's assertion of authority over interstate pipelines was contrary to the supremacy and interstate commerce clauses of the U.S. Constitution as the state's jurisdiction to regulate transportation of natural gas in interstate commerce and construction of facilities of an interstate pipeline had been preempted by the Natural Gas Act ("NGA").

While KIUC's action was pending, several federal courts issued decisions directly addressing this issue. In Michigan Consolidated Gas Co. v. Panhandle Eastern Pipe Line Co., 887 F.2d 1295 (6th Cir. 1989), cert. denied 494 U.S. 1079 (1990), National Steel Corporation ("National") arranged to transport gas to its plant outside of Detroit, Michigan, directly from Panhandle Eastern, an interstate pipeline, thus bypassing its LDC, Michigan Consolidated Gas Company ("Mich-Con"). Panhandle agreed to add the fittings and pipes to permit National to tap into its pipeline at the Great Lakes Steel Division in Michigan. Under the terms of its agreement with Panhandle, National would purchase gas in Oklahoma and pay

Panhandle to transport the gas directly to its steel mill in Detroit.

Panhandle applied for and ultimately received a Certificate of Public Convenience and Necessity from the FERC under Section 7(c) of the NGA authorizing the bypass and construction of the facilities necessary to construct it. Both Mich-Con and the Michigan Public Service Commission ("MPSC") opposed the application and unsuccessfully appealed the FERC decision. Michigan Consolidated Gas Co. v. FERC, 883 F.2d 117 (D.C. Cir. 1989).

While the FERC decision was pending, Mich-Con brought a formal complaint against the pipeline before the MPSC. National and Panhandle sought to enjoin MPSC action in federal court. A subsequent state court action by Mich-Con was ultimately filed, which was removed to federal court and consolidated with the injunction proceeding. Upholding the bypass and finding that NGA preempted MPSC from assuming jurisdiction over the FERC-certificated bypass, the federal district court entered judgment in favor of Panhandle and National. National Steel Corp. v. Long, 689 F.Supp. 729 (W.D. Mich. 1988).

On appeal, the Sixth Circuit Court of Appeals affirmed. The Court found that the Panhandle-National bypass did not constitute "local distribution within the meaning of the NGA. This holding is significant since the NGA specifically applies to "the transportation of gas in interstate commerce" but specifically excludes "the local distribution of natural gas." 15 U.S.C. §717(b). Noting that the retail sale of the gas occurs in Oklahoma

and that Panhandle's role is merely to transport it across several intervening states to National's plant in Michigan, the Court concurred with the lower court's conclusion that "[i]t is hardly conceivable that a transaction could fit more neatly into the category of transportation of natural gas in interstate commerce." 887 F.2d at 1300.

The Court refused to recognize Michigan's claim of jurisdiction over the bypass. Noting the "meticulously drawn statement of federal jurisdiction" and finding in the assumption of bypass jurisdiction by the MPSC "the imminent possibility of a collision between state and federal regulatory power that would disrupt this comprehensive scheme," it held that the NGA preempted the state of Michigan's power to regulate bypass. 887 F.2d 1301.

In Cascade Natural Gas Corp. v. FERC, 955 F.2d 1412 (10th Cir. 1992) the Tenth Circuit Court of Appeals reached a similar conclusion. The Washington Utilities and Transportation Commission ("WUTC") appealed FERC's issuance of a certificate to an interstate pipeline to construct bypass facilities. WUTC contended that the regulation of bypass construction implicates the same "local interests" and the same form of local regulation that Congress intended to reserve to the states when it enacted Section 1(b) of the NGA. It also contended that the interstate pipeline, by transporting gas through the bypass, had stepped directly into the shoes of the LDC, and consequently, its delivery of gas was the functional equivalent of local distribution.

The Tenth Circuit Court of Appeals summarily dismissed both contentions. It found that none of the §1(b) exclusions were intended to prevent FERC's exercise of jurisdiction over interstate transportation. "Quite simply, the bypass transactions do not entail the realm of local retail sales that Congress intended to reserve to the states." Id. at 1419. Finding that no local retail sale occurred in these types of transactions, the Court rejected the "functional equivalent" argument. Finally, the Court rejected WUTC's argument that it shared concurrent jurisdiction with FERC over such transactions. "It is settled that if the NGA grants jurisdiction to the Commission [FERC] over a matter, as it does here," the Court declared, "its jurisdiction is exclusive." Id. at 1421.

A third federal circuit has applied the same reasoning to reach similar results. In Public Util. Comm'n of California v. FERC, 900 F.2d 269 (D.C. Cir. 1990), the California Public Utilities Commission ("CPUC") challenged FERC's grant of a certificate permitting a pipeline company to construct a gas pipeline. FERC had rejected CPUC's claim of jurisdiction over the taps, meters and other tie-in facilities that linked the pipeline to end-users. FERC held that its own jurisdiction was exclusive over the entire pipeline.

Rejecting CPUC's claim that a transporter's facilities for delivery to an end-user constitute local distribution facilities, protected from federal jurisdiction under Section 1(b) of the NGA, and thus subject to state jurisdiction, the District of Columbia

Circuit Court of Appeals held that FERC's jurisdiction over the interstate transportation of natural gas was exclusive. Addressing CPUC's arguments concerning the need for state jurisdiction in light of the potential dangers of bypass, the Court stated that "the mere fact that changing circumstances may crimp the style of a state agency is scarcely a reason for a sharp shift in the interpretation of a federal statute." Id. at 277.

In view of these decisions, this Commission sought remand of its decision. Upon remand, the Commission invited all parties to submit written briefs on this issue. Delta Natural Gas Company, Louisville Gas and Electric Company, and Columbia Gas of Kentucky submitted briefs opposing any change in the Commission's position. KIUC, Columbia Gas Transmission Corporation, and Osram Sylvania submitted briefs in support of amending the earlier decisions to conform with the recent federal court decisions.

The opponents of conformity advance no new legal arguments. They insist that the federal decisions were erroneously decided and that the Commission should stay the course. They fail to cite any legal precedent which contradicts or questions the holdings of the three decisions previously discussed. Arguing that the Supreme Court has yet to address the issue and may, upon addressing it, reach a different conclusion, they counsel delay.

Delay, however, serves no useful purpose. The United States Supreme Court declined to review Michigan Consolidated. Absent a disagreement among the Federal Circuits, Supreme Court review of this issue is unlikely. Moreover, this Commission must comply

with the decisions of the Court of Appeals in whose circuit we are located.

The opponents of conformity advance several policy reasons to support their position. They note that regulatory oversight is necessary to prevent the duplication of facilities and protect the public interest. Without such oversight, unneeded and wasteful projects are likely to be constructed. Physical bypass of LDC facilities will leave fewer customers among whom to distribute costs and, therefore, is likely to increase rates for the LDC's remaining customers. By reducing an LDC's need and demand for gas supplies, bypass may also weaken its bargaining position with gas suppliers and thus increase purchased gas costs. Finally, bypass makes the collection of local taxes normally performed by LDCs more difficult and thus may create adverse financial impact on some local government units.

While these policy concerns have considerable merit, they alone are not enough. In deciding to exert exclusive jurisdiction over this area, the federal government has decided to emphasize other policy concerns. Only the federal government, through the United States Congress, can alter the present set of established priorities.

The Commission is not unmindful of potentially adverse effects of bypass. While we cannot prohibit bypass, we can ensure that those end-users who choose to bypass an LDC's system pay the costs imposed on remaining customers by their exit. We advise all LDCs that the Commission will consider the imposition of reasonable exit

and re-entry fees to protect remaining LDC customers. The reasonableness of any particular fee, however, must be determined on a case-by-case basis.

In summary, the Commission finds that the provisions of its Order of October 27, 1986 which related to interstate pipelines transporting natural gas to end-users conflict with federal law and should be vacated. We further find that the Order of October 27, 1986 should be amended to conform with existing decisional law.

IT IS THEREFORE ORDERED that:

1. Ordering Paragraph 3 of the Commission's Order of October 23, 1987 is vacated and stricken.

2. The Commission's Order of October 23, 1987 is amended to conform with the holdings of Michigan Consolidated Gas Co. v. Panhandle Eastern Pipe Line Co., Cascade Natural Gas Corp. v. FERC, and Public Util. Comm'n of California v. FERC.

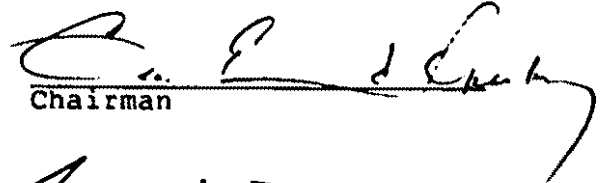
3. Interstate pipelines transporting natural gas for end-users are not required to apply for a Certificate of Public Convenience and Necessity before permitting any end-user to physically bypass the distribution facilities of an LDC.

4. Interstate pipelines are not required to submit annual reports on their service to end-users in Kentucky.

5. All other provisions of the Commission's Order of October 23, 1987 shall remain in full force and effect.

Done at Frankfort, Kentucky, this 18th day of August, 1993.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman


Commissioner

ATTEST:


Executive Director